Sarbanes-Oxley section 404
Impacts on European companies
Acknowledgements

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ABSTRACT

With the advent of corporate scandals in North America most notably the Enron case, the US congress passed the Sarbanes-Oxley Act to redress the situation. This act aims to restore confidence of investors in financial markets, and to improve the management of companies. The three main principles of the Act are: exactitude and availability of information, responsibility of managers, and independence of auditors. The section 404, which is one of the main sections of the act, deals with internal control and requires that management undertake an assessment of internal control over financial reporting. This section can be considered to be the focal point of the Sarbanes-Oxley law and is the main focus of our study. The Sarbanes-Oxley act is an American law but European companies who seek funds in the US markets also have to comply with the act. This led us to formulate the following question:

How does the section 404 of Sarbanes-Oxley Act impact on European companies in terms of Internal Control over Financial Reporting?

To answer the research question, we have chosen to undertake an exploratory study, concentrating on Sweden.

We have conducted our study using a qualitative method, making interviews to gather primary data. The companies we interviewed all had their headquarters located in Sweden and had to comply with SOX. We conducted four interviews with companies of different sizes, different industries and which most importantly, had implemented Sarbanes-Oxley for different reasons.

Basing our research on the following theory:

- Risks when realizing the financial statements.
- Material misstatements (errors) in financial reports.
- The Sarbanes-Oxley act,
- And more precisely the section 404 of the act,

We built up an interview guide that we used for the interviews. Our theory and the interview guide helped us to focus on key points during our research. We looked for the consequences of the implementation of Sarbanes-Oxley, the impact of section 404 on material errors, the European perspective following Sarbanes-Oxley and the general point of view of the interviewees.

The result of our studies is that the implementation of the section 404 of the Sarbanes-Oxley Act had a positive impact on the companies. Indeed many improvements have been noticed after the implementation of Sarbanes-Oxley, such as the improvement of the organization of the company, the level of competence of the employees (especially of the management and the employees of the financial department), better communication, and improved IT systems. Companies are more able to focus on internal control and they recognize that it’s an important and useful tool for the company. Companies also agreed on the benefits of the COSO framework for developing internal control within the company.
Chapter 1: Introduction

1.1. Background
1.2. Research Question
1.3. Objectives
1.4. Limitations of the study

Chapter 2: Research considerations

2.1. Methodological considerations
2.1.1. Choice of subject
2.1.2. Theoretical preconceptions
2.1.3. Perspective of the study
2.1.4. Underlying philosophy
2.1.5. Research Method
2.1.6. Scientific approach
2.1.7. Research Design

2.2. Collection of data
2.2.1. Collection of primary data
2.2.1.a. Selection of the companies
2.2.1.b. Interviews process

2.2.2. Collection of secondary data

2.3. Criticism of data
2.3.1. Criticism of primary data
2.3.2. Criticism of secondary data

2.4. Validity criteria
2.4.1. Researchers’ discussion about validity in case studies
2.4.1.a. Validity criteria
2.4.1.b. Generalization
2.4.2 Credibility of our study

Chapter 3: Theoretical framework

3.1. Risks and Risk management
3.2. Material misstatements in financial reporting
3.2.1. Detection of material items
3.2.2. Material misstatements and Internal control over financial reporting

3.3. Sarbanes-Oxley
3.3.1. General presentation of the law

3.3.2. Section 404
3.3.2.a. Internal control definition
3.3.2.b. Section 404 overview
3.3.2.c. Compliance with section 404
Section 404 Compliance Review Work Breakdown Structure

3.4. An internal control framework: the COSO Model
3.4.1. The PCAOB and its Auditing Standards
3.4.1.a. Internal control over financial reporting
3.4.1.b. Limitations inherent to internal control over financial reporting
3.4.2. Framework for assessment by the management under Auditing Standard 2
3.4.2.a. Requirements
3.4.2.b. COSO
Chapter 4: Empirical Findings

4.1/. Findings from the first company

4.1.2/. General background of the company
4.1.2/. The interviewee
4.1.3/. Findings
4.1.3.a/. Consequences of the implementation of section 404 of SOX
4.1.3.b/. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements
4.1.3.c/. SOX and the European and national perspective
4.1.3.d/. Global assessment

4.2/. Findings from the second company

4.2.1/. General background of the company
4.2.2/. The interviewee
4.2.3/. Findings
4.2.3.a/. Consequences of the implementation of section 404 of SOX
4.2.3.b/. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements
4.2.3.c/. SOX and the European and national perspective
4.2.3.d/. Global assessment

4.3/. Findings from the third company

4.3.1/. General background of the company
4.3.2/. The interviewee
4.3.3/. Findings
4.3.3.a/. Consequences of the implementation of section 404 of SOX
4.3.3.b/. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements
4.3.3.c/. SOX and the European and national perspective
4.3.3.d/. Global assessment

4.4/. Findings from the fourth company

4.4.1/. The interviewee
4.4.2/. The findings
4.4.2.a/. Consequences of the implementation of section 404 of SOX
4.4.2.b/. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements
4.4.2.c/. SOX and the European and national perspective
4.4.2.d/. Global assessment

4.5/. Summary of empirical findings

Chapter 5: Analysis of the data

5.1/. Introduction
5.1.1/. Reasons for implementing SOX
5.1.2/. Implementation process

5.2/. Changes with the implementation of SOX
5.2.1/. Organization perspective
5.2.2/. Timing considerations
5.2.3/. Cost considerations
5.2.4/. Processes

5.3/. Internal Control over Financial Reporting and the reduction of material errors in the financial reports

5.4/. SOX section 404 and the European perspective

5.5/. Global assessment
Table of contents

Chapter 6: Conclusions ----------------------------------------------- 68

Chapter 7: Further Research------------------------------------------ 70

Tables

Table 1: Case Study Tactics for Four Design Tests ------------------- 14
Table 2: Financial figures SKF -------------------------------------- 36
Table 3: Key financial figures for Concordiabus---------------------- 42
Table 4: Summary of empirical findings----------------------------- 60

Table of figures

Figure 1: Case study method------------------------------------------ 8
Figure 2: General presentation of SOX------------------------------- 22
Figure 3: Section 404 Compliance Review Breakdown Structure------- 25
Figure 4: Planning considerations for section 404 compliance audit 26
Figure 5: COSO five layouts description----------------------------- 34
Figure 6: Geographical ownership----------------------------------- 37
Figure 7: Implementation phases of SOX at C4----------------------- 53
CHAPTER 1: INTRODUCTION

This first chapter gives a general presentation of the area we are working on, in order to give a general background to the reader. The aim is to generate the research question. Moreover, it defines the objectives and limitations of our study.

1.1/ Background

Although there are many rules and principles established by recognized international and national rule setters in the accounting field, companies sometimes fail to publish reliable financial statements. This creates a reduction of confidence among investors and other users of financial statements. In 2001, for instance, the Enron scandal revealed the importance of setting new rules to protect shareholders against inefficient management and companies that are supporting inefficient managers. Enron executives violated US GAAP, and gave unfair representation of the financial health of the company. Enron also used communication to convince and mislead investors making them believe that the company was performing well. Unfortunately Enron was not the only company involved in financial scandals, with financial irregularities at companies such as Tyco, Sunbean or Worldcom also affecting capital markets. Nor was it a problem restricted to the US with European countries experiencing their own scandals.

Following these financial scandals, a need to rebuild trust between the shareholders and the organizations has arisen. The first step in this process is more transparent reporting, through the provision of more relevant information and enhanced notes to make financial statements more understandable. The second step towards rebuilding trust, and creating a favourable environment of strong accountability, fairness and transparency of financial reporting, is through corporate governance. Solid governance of an enterprise rests on an appropriate statement of the roles and responsibilities of the functions of management, auditing and fraud examination.

Concentrating on this need for trust, the Sarbanes-Oxley law (SOX) has been introduced. The long-term benefits of Sarbanes-Oxley for investors have been described as: the reduction of risk of losses due to fraud and theft, more reliable financial reporting, greater transparency and accountability. The Sarbanes-Oxley Act was accepted by Congress and the Senate, and later turned into law by the President of the United States in 2002. This Act requires that the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of the companies listed in US stock markets certify their Internal Control over Financial Reporting, and that those companies have an external auditor to attest the effectiveness of this reporting to the Securities and Exchanges Commission (SEC). This implies that the CEO and CFO of the companies themselves certify that the financial statements are fair, and reflect reality. A big implication of SOX is that it now brings penal sanctions against management in case where false financial statements have been signed off as being true.

There are three main principles in this Act: the accuracy and availability of information, the responsibility of the managers, and the independence of the auditors. The Sarbanes-

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Oxley Act is composed of different sections relating to different issues. An important section is section 404, which deals with internal control, and requires that there be an assessment of internal control over financial reporting. This section can be considered the highest focal point of the Sarbanes-Oxley law and is quite innovative in terms of internal control.

As a result of the Sarbanes-Oxley law the last few years, have seen the definition of internal control become a more and more important issue. The Committee of Sponsoring Organizations, an association which aims at improving the quality of financial reporting, defined internal control as “a process, affected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.”

The rules introduced by section 404 of the Sarbanes-Oxley law, concerning internal control, require that:

*Management perform a formal assessment of its control over financial reporting, including testing to confirm both the design and operating effectiveness of the controls.*

*Management include in its annual report on Form 10-Kxiv an assessment of internal control over financial reporting.*

*The external auditors provide three opinions as part of a single integrated audit of the company, instead of the one previously provided. This includes:*

- An opinion on management’s assessment
- An independent opinion on the effectiveness of the system of internal control over financial reporting
- The traditional opinion on the financial statements”

For many companies, this obligation of internal control is new, and represents a challenge. Compliance with this law will lead all the different departments of a company to work together. This “working together” will naturally improve and reinforce corporate governance in firms.

This law and its requirements are new for all companies, and the question of its efficiency in preventing accounting fraud for these companies remains. Furthermore, even though it is an American decision, this law has significant consequences for European companies.

European companies are evolving in an international context. Indeed, the need for more and more capital has forced them to look for money outside Europe, thus raising the legal need of compliance with foreign business laws (for instance American, Japanese or Chinese laws...). Moreover, Europe has also had to face some important financial scandals such as the Parmalat scandal in 2003, or the Ahold scandal in 2003, with both scandals involving accounting manipulations in international companies. Those

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2 Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004
3 Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004
scandals and the new USA regulation through the Sarbanes-Oxley act, led the European Union to try to enforce legislation regarding corporate governance through the creation of COM. 284, a communication, published by the European Commission to the Council and European Parliament, regarding the enhancement of corporate governance and including guidance for internal control. Thus if European companies have to comply with different laws regarding the same matters, one can wonder if the benefits outweigh the costs of European companies having to comply with multiple duplicate laws.

The application of the Sarbanes-Oxley act to European companies leads to the following research question:

1.2/. Research Question

How does section 404 of Sarbanes-Oxley Act impact on European companies in terms of Internal Control over Financial Reporting?

1.3/. Objectives

This study aims to identify the different implications of the section 404 of the Sarbanes-Oxley Act for European companies, and so to understand the mechanisms of internal control.

Identifying the implications of such a law would help us to describe the advantages and disadvantages concerning the implementation of internal control within a company.

Moreover, it would assess whether internal control over financial reporting can be an efficient way to improve financial reporting fairness and transparency.

Finally, it would help companies to get an insight of the positive and negative impacts of SOX section 404.

For a better understanding, we would like to underline that, along the thesis, when we talk about SOX, it is more specifically SOX section 404 as it is the focus of our research.

1.4/. Limitations of the study

In order to analyse the impact of section 404 of the Sarbanes-Oxley Act on European companies in terms of Internal Control over Financial Reporting, we have decided to conduct an exploratory study concentrating our efforts on Swedish companies implementing Sarbanes-Oxley.

We excluded subsidiaries of American or other European companies implementing Sarbanes-Oxley to have a national vision of the phenomenon. This decision was reinforced by one of our respondents who explained to us that American subsidiaries did not have a say in the implementation process of Sarbanes-Oxley but just had to

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follow the orders coming from the US or from wherever their mother company was.
CHAPTER 2: RESEARCH CONSIDERATIONS

In this chapter, the choices made in terms of research method and reasoning are explained and linked to our topic of interest. The collection of data is presented, together with a criticism of the sources used to construct our study. This part of our work also presents the credibility criteria of our thesis.

2.1/. Methodological considerations

2.1.1/. Choice of subject

The Arthur Andersen and associated financial scandals of 2002 had a huge impact on the financial world. This auditing company has disappeared not only in the United States, but also in the rest of the world. This shows that such an event happening in the United States also has an impact on European countries. Following these scandals, the need to bring back confidence to shareholders has increased everywhere in the world, the financial world is still feeling the consequences, and companies are still looking for ways to improve control (management control, risk control etc).

Studying in the field of finance and accounting, we are particularly interested in financial reporting fairness and transparency and the existing solutions for improving these. One way to improve financial reporting is through internal control. As one of us wants to work in auditing, and the other in internal control, our job tomorrow will deal with these kinds of issues. It is therefore interesting for us to be aware of such matters, and understand them.

2.1.2/. Theoretical preconceptions

Internal control has not been deeply studied in the classes we have followed, neither in France nor in Sweden for our Master in Accounting and Finance. Therefore, our knowledge of internal control was not highly developed before studying the Sarbanes-Oxley Act. However, we both have an educational background in Business Administration, with a specialisation in finance and accounting, hence we have some knowledge of the relationships between the corporate world and auditing firms as well as more general perspective of the field of finance.

At the professional level, we both have some experience in the area of external audit, having done internships with auditing firms. Hence, we had some ideas that the topic was of interest to us, and had some knowledge of the large area that is auditing. In the area of internal auditing, however, neither of us had specific knowledge about it before starting our Masters thesis.

Consequently, neither writer had any preconceptions directly relating to the research area since we did not have any strong background in internal control, and did not know of the existence of the Sarbanes-Oxley Act in the United States.

2.1.3/. Perspective of the study

As a researcher, it is important to choose a perspective from which the research will be conducted. Indeed, the study, the analysis, and, therefore, the results can differ
depending on which perspective the researcher is working from.

We have decided to analyse the implications of this American law on internal control from a European company’s point of view, and in particular from the perspective of the people responsible for the SOX project within those companies. It was, for us, the most interesting perspective to consider in terms of results, and the most useful for these European companies themselves. By doing so, they could understand and analyse some of the implications of SOX (Sarbanes-Oxley).

### 2.1.4. Underlying philosophy

Generally speaking, two broad spheres are defined in the research philosophy: Ontology and Epistemology.

- Concerning the ontological considerations, “the central point of orientation here is the question of whether social entities can and should be considered objective entities that have a reality external to social actors, or whether they can and should be considered social constructions built up from the perceptions and actions of social actors.”

- Concerning the epistemological considerations, the issue concerns what should be regarded as an acceptable knowledge in a discipline. “A particularly central issue in this context is the question of whether the social world can and should be studied according to the same principles, procedures and ethos as the natural sciences.”

For our study we agreed with the epistemological considerations. We have tried to discover the impact of the implementation of section 404 of SOX in European companies. Therefore, we chose to adopt a behaviour that helps us to understand how people we interviewed analysed the changes in their companies after the implementation. Thus, we can say that our position regarding the interpretation of knowledge in this thesis is an interpretivist one.

### 2.1.5. Research Method

In order to obtain the desired results, the choice of research method is essential in the researchers’ work. Usually, two different research methods are distinguished: qualitative research and quantitative research. “Qualitative research usually emphasizes words rather than quantification in the collection and analysis of data”, while quantitative research emphasizes more quantification. In quantitative research, the analysis of data is generally done on the basis of statistical reasoning. In comparison, the qualitative method tends to be less structured, and can be more flexible than the quantitative method.

To have relevant information, and to give good answers to our research question, we have chosen to use qualitative research. We need to understand how European companies have reacted to comply with the Sarbanes-Oxley Act, and what changes and improvements have been made to be SOX compliant. Therefore, the information

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7 A. Bryman and E. Bell, Business research methods, Oxford edition, Oxford, 2003, p 573
required to efficiently address our topic is not written material, and can only be obtained from a small number of people in the contacted companies. As a result, the most effective way to access this information was to directly contact the people in charge of the project at each company.

This qualitative method gives us more flexibility in the conducting our research, as the interviewees can focus on different areas that they determine to be relevant and related to our research question. It enables less structured interviews (either semi structured or unstructured); and so, provides more freedom for the interviewees to explore the areas they consider to be interesting in this area.

2.1.6. Scientific approach

Usually, the main orientation of the role of theory in relation to research is deductive for quantitative research and inductive for qualitative research. A deductive approach supports the testing of theories, while an inductive approach encourages the generation of theories. But the researcher does not have to keep exactly to this scheme; the approaches can be changed according to what the researcher wants.

In fact, we do not use an inductive approach, given that we needed to find some information to be able to get the data for the empirical analysis. It was not possible to structure a questionnaire and to lead the interviews with the companies without having some background ourselves. As a result, after the theory, we went to search for the empirical data, according to the principle of the deductive research approach.

2.1.7. Research Design

As stated in the limitations of our thesis, we are undertaking an exploratory study. It enables us to focus on the Swedish companies while studying the implementation of Section 404 in the European context. An exploratory study helps researchers to “develop concepts more clearly and establish priorities” and it may also save time and money for the researchers. In this context, we are conducting multiple case studies.

In order to comply with the objective of our research, field studies (or multiple case studies) appeared to be the best research strategy to use. The term “fieldwork” is often used in connection with case study research in the literature. In the field of accounting and finance, this could be the study either of a single organization or several organizations; whereas a case study usually implies the study of a single organization. The methodology for the field studies is quite the same as the one for case studies, but at a less extensive level.

To help us understand, a case study can be defined as: “an empirical inquiry that:

- Investigates a contemporary phenomenon within its real life context; when
- The boundaries between phenomenon and context are not clearly evident; and in which

• *Multiple sources of evidence are used.*

**Figure 1: Case study method**

This scheme describes the method to consider when using a case study approach, with multiple case studies. We followed this reasoning when collecting our data for the empirical part of our study.

The research design is the logic linking the data to be collected to the initial research question of the study; it is the plan connecting these two elements. The main purpose of a design is to avoid the situation where the evidence does not supply relevant answers to the research question. As we have said, we will use multiple case studies, or field studies, as a research design. The sources of information used in field studies can be: documentation, archival records, interviews, direct observation, participant information, and physical artefacts. Our main sources consist of documentation and interviews.

### 2.2. Collection of data

#### 2.2.1. Collection of primary data

Primary data are those collected by the researchers themselves directly at the information source. Primary data are "sought for their proximity to the truth and control"
Research considerations

over error”\textsuperscript{15}. These data are the data we collected from interviews with some of the companies implementing SOX in Sweden. We also had an interview with a person from an international auditing firm, who preferred not to be mentioned in the report. This information helped us in our reasoning and construction of the theoretical framework.

To describe our interviews and interview guide (appendix 2), we can say that we used semi-structured interviews, as they “\textit{are the most important form of interviewing in case studies}”\textsuperscript{16}. The interview process itself is a key process since “\textit{the questions are mainly open and require an extended response with prompts and probes from the researcher to clarify the answers}”\textsuperscript{17}, the researcher also has to be able to build trust with the respondent to have as many reliable and quality data as possible.

2.2.1.a/. Selection of the companies

We were looking for companies implementing Sarbanes-Oxley in Sweden.

Our first step was to look for some theses realized in Sweden but written in English. In one of them\textsuperscript{18}, we found out that an article published in the Swedish newspaper Balans in 2005 listed the companies implementing SOX in Sweden.

Our second step was to consult the US Security and Exchange Commission website where we found a larger list of Swedish companies listed with the SEC\textsuperscript{19}. We tried to contact the companies, with some success to take part in the final interviews. Some of the companies were not listed anymore but had been listed at some point in their existence. We needed a minimum of three interviews for our field study and we used all the companies implementing SOX, which responded positively to our request for interviews.

As we did not have any specific contact name with Swedish companies, we first sent a series of emails at the investor relations department of the companies. Then we usually called the general number of the company and asked for the finance department. The people we talked to in the finance departments helped us to get in contact with the people in charge of SOX in their companies. Then, if the SOX manager had time, we were able to obtain an interview.

2.2.1.b/. Interviews process

Our primary data were obtained through phone interviews, conducted in English. We chose to undertake phone interviews for two reasons. Firstly because we were unable to find any Swedish companies implementing Sarbanes-Oxley in Umeå. Most of the companies implementing Sarbanes-Oxley in Sweden are located in the south of Sweden (mostly in Stockholm and Göteborg). Secondly because it was, unfortunately, not possible for us (for reasons of time and money) to go and spend some time in the south of Sweden.

\textsuperscript{15} D. Cooper and P. Schindler, \textit{Business research methods}, 8\textsuperscript{th} edition, McGraw-Hill edition, Boston, 2003, p87

\textsuperscript{16} Bill Gillham, \textit{Case study research methods}, Continuum, Real World Research, London, 2000, p63-66

\textsuperscript{17} Bill Gillham, \textit{Case study research methods}, Continuum, Real World Research, London, 2000, p63-66

\textsuperscript{18} G.Nilsson, P.Petkovski and T.Raiha, \textit{The implementation and effects of SOX in Swedish companies}, 2005

\textsuperscript{19} http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&State=V7&owner=include&count=40
Prior to each interview we introduced the respondents to our subject, research question, and a list of topics that we would like to discuss with them. In the case of the respondents agreeing to give us an interview we emailed them a copy of our interview guide after arranging a date for the phone interview. The interviews were planned to last a maximum of one hour and were recorded with the agreement of the respondents. We had four interviews with different people in charge of the SOX project at their respective companies and the interviews lasted 48 minutes, 51 minutes, 31 minutes, and 41 minutes. The topics of our interviews were based on the theories we have found. Our principal intention was to see if section 404 of the Sarbanes-Oxley Act, and more precisely, Internal Control over Financial Reporting had impacted on the companies in a positive or negative way. Thus we started our interviews asking the respondents to briefly introduce themselves, followed by the implementation process of SOX 404. Thereafter we asked them to focus on the consequences of the implementation of SOX.

During the interviews we asked the respondents all the questions from the interview guide. Sometimes during the interviews we tried to reformulate what the respondents said to confirm our understanding of what they were telling us. We also added some questions if we needed clarification of issues the respondents brought to our attention during the interviews. At the end of the interviews the respondents usually asked us to send them a copy of our work both for review and to be able to see our conclusions about the subject.

The recorded material was transcripted word for word, to be summarized and emailed for corrections to the respondents before our final analysis and conclusions. The summaries of the interviews are the base of our empirical findings. One respondent asked us to make some minor changes to our empirical findings (which we did), whilst another respondent did not ask for any changes and sent us some documents to complete our empirical findings about the company. The two other respondents did not correct our empirical findings; one did not answer our email concerning the matter, whilst the other was unable to allow the disclosure of his or his company’s name due to common policy.

2.2.2/. Collection of secondary data

The secondary data “have had at least one level of interpretation inserted between the event and its recording” 20. These secondary data, in which the researchers are not implicated, come from scientific articles, literature and reports. All this information is presented in the theoretical framework.

We used secondary data mostly to construct our theoretical framework and to find some useful information to describe the companies we worked with.

To construct our theoretical framework, we used the search tools at the Umeå University library. We collected books from ALBUM and useful articles from different databases such as EMERALD and Business Source Premier. Key words for our research have been for instance: financial report fairness, financial report reliability, companies’ risk, effects of Sarbanes-Oxley section 404 and Sarbanes-Oxley section 404. We equally had some useful article about field study and were then able to find

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even more articles in the reference sections of those articles\textsuperscript{21}. We also used the search engine Google to find useful information about companies we had interviewed, and to find information about the Sarbanes-Oxley act itself, the PCAOB (Public Company Accounting Oversight Board), the Security and Exchange Commission and the COSO (Committee of Sponsoring Organizations) framework for instance. We finally also used information provided by auditing firms, because through our literature we understood that the auditors’ role in the implementation process of SOX was important. Auditors can have to implement SOX in different companies and thus have a global knowledge of the comments made by their clients during and after the SOX implementation process.

After the collection of data, we examined the articles and wrote the theoretical framework of our study. Section 404 of the Sarbanes-Oxley act was a crucial part of our study, as the COSO framework. The general information about companies risk and error in financial statements were also useful in understanding the goals of Internal Control over Financial Reporting, which is to reduce the risk of errors in financial reports.

2.3/. Criticism of data

2.3.1/. Criticism of primary data

For the collection of our primary data, we decided to make phone interviews. We are aware of the weaknesses of such a process to get qualitative data from companies, we thought the quality of the data would not be greatly affected by this method of interviewing. We needed the information from the relevant people (contacted by phone) in the different companies. Telephone interviews have developed a lot the past few decades, because they offer some of the advantages of face-to-face interviews such as responsiveness and reflexivity, but without the costs incurred by face-to-face interviews (time and money)\textsuperscript{22}.

Alan Bryman and Emma Bell present several other advantages related to telephone interviews:

- On a like-for-like basis, they are far cheaper and also quicker to administer
- The telephone interview is easier to supervise than the personal interview
- In face-to-face interviews, respondents’ replies are sometimes affected by the characteristics of the interviewer\textsuperscript{23}.

However, there are some weaknesses in this kind of interviewing method:

- People who do not own or who are not contactable by telephone cannot be interviewed by telephone.
- Telephone interviews cannot engage in observation.
- It is probably more difficult to ascertain by telephone interview whether the correct person is replying.

\textsuperscript{21} Gary Cunningham, ‘Management Control and Accounting systems under a competitive strategy’, Accounting auditing and accountability journal, volume 5, No.22, 1992, p85-101
\textsuperscript{22} Bill Gillham, Case study research methods, Continuum, Real World Research, London, 2000, p 77
\textsuperscript{23} A. Bryman and E. Bell, Business research methods, Oxford edition, Oxford, 2003, p120
Research considerations

- The telephone interviewer cannot readily employ visual aids.\(^{24}\)

For us, the advantages of telephone interviews outweighed the disadvantages. It was easier for us to have answers by phone than in person from the companies.

For the interviews, there are two different types of response errors: those initiated by the participant, and those by the interviewer. The errors that can be made by the participant are caused by an incomplete and non-accurate answer, either by choice, or by lack of knowledge. The errors made by the interviewer relate to the way he asks the question and his control over the process and can affect the quality of the information collected\(^ {25}\).

For the different interviews we had, we tape-recorded the discussion in order to reduce this risk of errors, and also because of the large amount of information we were expecting from them. Indeed, with the later transcription of these records, there was no loss of information when analysing it. Moreover, it was easier for the interviewers to really concentrate on the discussion, rather than on writing down responses. As a result, this enabled us to reduce the risk of misinterpretation when using these data.

### 2.3.2/. Criticism of secondary data

The other problem concerning data relates to the information we get from auditing firms. They are not, in fact, implementing Sarbanes-Oxley within their companies, but are benefiting from the implementation because the auditors need to spend much more time within the clients’ companies on SOX projects, this way the auditing firms increase their revenue. Therefore, the risk is that the SOX projects appear harder in their reports to implement SOX than it is in reality, in order to motivate their customers—the SOX compliant companies—to hire their services. Despite this, we thought that it was very interesting information, as they are involved in the implementation as advisors and as auditors of the internal controls; and they were able to give us an external and more general point of view of the implications of SOX.

### 2.4/. Validity criteria

#### 2.4.1/. Researchers’ discussion about validity in case studies

##### 2.4.1.a/. Validity criteria

The usual concepts used to determine the validity of a study are: measurement validity, internal validity, ecological validity, reliability and replicability. However, researchers question the applicability of these criteria for the case study research design. It depends particularly on the researcher’s feeling of how far these criteria can be appropriate for the evaluation of his case study research. Researchers argue that it is not the purpose of the case study to make generalizations for other or cases beyond the actual context of the case study\(^ {26}\), that case studies are not designed to produce scientific generalizations\(^ {27}\).

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Case studies are, by definition, “small sample” studies. Researchers usually apologise that the size of the sample used in the study does not enable them to generalise their findings, because they are specific to a given studied context. This raises the question of the criteria to use when assessing the quality of case study research.

2.4.1.b/. Generalization

There are two kinds of generalization: statistical generalization, and theoretical -or analytical- generalization. Statistical generalization is the most recognized method of generalization, but it is not the most appropriate when relating to case studies. “In statistical generalization, an inference is made about a population (or a universe) on the basis of empirical data collected about a sample.” This cannot be applied to case studies. Considering theoretical generalization, it can be used in a single case study, or in multiple case studies. It deals with “case studies in new or different contexts are used to generalize (extend) the theory to a wider context.”

Nowadays, however, it appears that, generally speaking, the term of “generalization” is avoided. According to Lincoln and Guba, “the only generalization is: there is no generalization.” Instead of talking about generalization, researchers prefer to talk about “transferability of the findings from one context to another.” For them, case studies offer some “working hypotheses” that can help in understanding other cases. The help provided can be assessed as appropriate by analysing the similarities between source and target cases. However, some researchers criticize this idea of transferability; according to them it does not enable us to draw general conclusions, which are necessary when conducting this kind of study. This stands for all case studies, except for ‘intrinsic case studies’, which are of sufficient interest for a target audience, and so have intrinsic value, but this is not the main situation. There are a lot of open questions related to the generalization of case studies’ findings.

There are different opinions about the relevant credibility criteria to use for case studies. We have chosen to take into consideration more specifically the idea of Yin, considering it to be the more structured, more understandable, and better-recognized set of criteria.

2.4.2/ Credibility of our study

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33 Y Lincoln and E.Guba, The only generalization is: there is no generalization, article in Case Study Method, edited by R. Gomm, M. Hammerley and P. Foster, Sage publications, London, 2002, chapter 2, p 27
35 Y Lincoln and E.Guba, The only generalization is: there is no generalization, article in Case Study Method, edited by R. Gomm, M. Hammerley and P. Foster, Sage publications, London, 2002, chapter 2, p 27
Yin states that we can judge the quality of any research design by a set of four logical tests, given that a research design is done to present a set of logic statements. Four tests are considered relevant to assess the quality of a case study. Yin presents the four tests, presented by Kidder earlier, and the tactics to deal with them:

- **Construct validity:** *establishing correct operational measures for the concepts being studied*
- **Internal validity** (for explanatory or causal studies, and not for descriptive or exploratory studies): *establishing a causal relationship, whereby certain conditions are shown to lead to other conditions, as distinguished from spurious relationships*
- **External validity:** *establishing the domain to which a study’s findings can be generalized, or generalisation*
- **Reliability:** *demonstrating into the operations of a study - such as the data collection procedures- can be repeated, with the same results.*

The goal of reliability is to reduce the errors and biases in a study.

An efficient way to present these tests and the tactics we can use to judge the quality of our research is in the form of a table, given by Yin:

<table>
<thead>
<tr>
<th>Tests</th>
<th>Case Study Tactic</th>
<th>Phase of Research in Which Tactic Occurs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construct validity</td>
<td>- Use multiple sources of evidence</td>
<td>- Data collection</td>
</tr>
<tr>
<td></td>
<td>- Establish chain of evidence</td>
<td>- Data collection</td>
</tr>
<tr>
<td></td>
<td>- Have key informants review draft case study report</td>
<td>- Composition</td>
</tr>
<tr>
<td>Internal validity</td>
<td>- Do pattern matching</td>
<td>- Data analysis</td>
</tr>
<tr>
<td></td>
<td>- Do explanation buildings</td>
<td>- Data analysis</td>
</tr>
<tr>
<td></td>
<td>- Do time-series analysis</td>
<td>- Data analysis</td>
</tr>
<tr>
<td>External validity</td>
<td>- Use replication logic in multiple case studies</td>
<td>- Data collection</td>
</tr>
<tr>
<td>Reliability</td>
<td>- Use case study protocol</td>
<td>- Data collection</td>
</tr>
<tr>
<td></td>
<td>- Develop case study database</td>
<td>- Data collection</td>
</tr>
</tbody>
</table>

Table 1: Case Study Tactics for Four Design Tests

As we are not conducting an explanatory or causal case study, the tests that are of

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interest for us in order to assess the quality of our research design are: construct validity, external validity, and reliability. It can be seen in our data collection part of the study that we have complied with all the necessary criteria. All the steps and tactics have been respected when conducting our study. The validity of our research design is then demonstrated as positive, based on the use of the different tactics presented in the conduction of our research.
CHAPTER 3: THEORETICAL FRAMEWORK

Our research question takes place in the large framework of financial reporting fairness and transparency. A solution that has been found is the Sarbanes-Oxley law. For a good understanding of our study, we first define corporate risks, which are the reason why companies have to find processes to secure their operations. Then we present the general topic of material misstatements in financial statements. An introduction of the Sarbanes-Oxley act, and its theoretical implications on the companies follows. We then explain section 404 in more detail and thus the necessities of control for companies. Finally we explain an internationally recognized method of internal control, the COSO framework.

3.1. Risks and Risk management

Risk is a major issue for companies all over the world, as companies have to take some risks to realize high profit. However, they also have to manage these risks if they want to operate in the long run. In the context of our research area, the understanding of risk and risk management is necessary to better understand the objectives and benefits of internal control.

Risk can be defined “as a concept used to express uncertainty about events and or their outcomes that could have a material effect on the goals and objectives of the organization. Companies have to face different sorts of risks”. To efficiently manage these risks they first have to assess them, then measure them, control them and monitor them.

Risks differ depending on the industry of the company and the regulations and market associated with that industry, meaning companies will have to assess risks differently. Some examples of risks faced by different companies are

1. Risks on intangibles and non balance sheet items e.g. brand, capital knowledge, reputation (customers), channels, supply chain (suppliers), intellectual assets etc.

2. Risks on physical tangible items e.g. buildings or raw materials etc.

In the scope of our research area we are going to concentrate on financial risks and more precisely risks linked to the establishment of financial reporting. Considering companies’ disclosure requirements regarding risks, there are four types of risk: market risks, operational risks, credit risks and accounting risks. These risks are closely linked

to the realization of financial statements.

(3) Market risks regard the quantitative information associated with derivative instruments and other financial instruments (interest rates, foreign exchange rates, commodity rates, equity prices etc)

(4) Credit risks mostly deal with long-term debt.

(5) Operational risks are concerned with capital, resources, liquidity, capital needs, material changes…

(6) Finally, accounting risks are linked to wrong estimates possible when evaluating some items in the balance sheet.

To face these risks, companies will have to implement different methods of risk management. Risk management can be viewed as the process followed by risk assessment, and can be considered as companies’ behaviour when deciding how to face risks. Companies can decide to try to control risk, transfer it to another entity, share the risk with another organization, diversify or avoid the risk. Research has been done about risk management and different processes exist such as the Enterprise Risk Management Process developed by Proviti, a risk consulting and internal audit firm, Strategic management; business planning but also internal auditing and internal control. These processes will help companies to effectively manage their risk.

Not managing those risks can lead to errors in the financial reports and more globally to lack of fairness and transparency in financial reporting. This second part will discuss the topic of material misstatements in Financial reporting more in details.

3.2/. Material misstatements in financial reporting

Material misstatements in financial reporting can be due to human errors, to companies’ intent to hide loss that could be covered in the short term (thus not seen by the investors), or to fraud. In the context of the Sarbanes - Oxley act and financial scandals, we have chosen to focus our thought on material misstatements, because it is one of the principal ways to induce readers of financial reports into taking wrong decisions concerning investments in a company, lending money to a company and so on.

3.2.1/. Detection of material items

A misstatement is considered material when it can affect the decision of investors, potential investors or other stakeholders, when taking decisions regarding the company they are interested in. Material misstatements in financial statements can occur for different reasons such as errors or frauds. Internal control is one of the most efficient

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46 AU sec 316 on http://www.sec.gov/rules/pcaob/34-49544.htm
ways to prevent material misstatements in financial reports.\textsuperscript{47}

When implementing SOX, companies have to define which accounts of their financial reports can be defined as significant. “An account is significant if there is a more than remote likelihood that it contains misstatement that could have a material effect on the financial statements\textsuperscript{48}.” The significance of the account can be based on quantitative or qualitative aspects.

To determine the significant accounts, managers have to consider their materiality. Materiality is not just a quantitative concept, and there is some subjectivity involved when judging the materiality of an account, as materiality evolves and can change through the process.\textsuperscript{49}

An example of quantitative considerations when looking for materiality can be to apply a materiality threshold to an account or group of accounts, for instance 5\%, against certain key metrics such as pre-tax income. The materiality threshold can be useful making a preliminary assumption about whether an item is likely to be material or not.

An example of qualitative consideration when looking for materiality can be:

- The composition of the account
- The nature of the account
- The susceptibility to loss due to errors or fraud
- The volume of activity, complexity and homogeneity of the individual transactions processed through the accounts. (...)?\textsuperscript{50}

Identifying significant accounts will help managers to implement effective controls within the company and to reduce the likelihood of material misstatements in the financial reports.

To identify the significant account:

- The managers can start by analysing their company’s consolidated financial statements (example: Revenue as reported in the consolidated financial statements)
- Then he or she will have to define the significant accounts and disclosures (Example: Revenue from services)
- Then the business processes/cycles (Example: service revenue business process)
- Then the business process sub processes/sub cycles (Example: sales order entry)

\textsuperscript{47} AU sec 316 on http://www.sec.gov/rules/pcaob/34-49544.htm
\textsuperscript{48} Sarbanes-Oxley Act section 404, Practical guidance for management, Price Waterhouse Coopers, July 2004
\textsuperscript{49} Sarbanes-Oxley Act section 404, Practical guidance for management, Price Waterhouse Coopers, July 2004
\textsuperscript{50} Sarbanes-Oxley Act section 404, Practical guidance for management, Price Waterhouse Coopers, July 2004
Then information processing objectives and financial statements assertions
(Example: all sales are invoiced and posted to the accounts receivable subsidiary ledger, completeness assertion)

And finally controls (Example: The accounts receivable supervisor reconciles daily service sales to the invoice registered to the posting in the accounts receivable subsidiary ledger on a weekly basis. The controller reviews the reconciliation upon completion.\textsuperscript{51})

3.2.2/. Material misstatements and Internal control over financial reporting

The work of auditors, in certifying the effectiveness of Internal Control over Financial Reporting in a company, is closely linked to the work of managements when implementing an effective internal control over financial reporting in their company. That is why when using PCAOB Auditing Standard number 2, one can have a vision of the managers’ work.\textsuperscript{52}

Paragraph 8 of Auditing Standard number 2 PCAOB starts by defining \textbf{control deficiency}. A control deficiency occurs when management or employees fail to detect misstatements on a timely basis. There are two kinds of deficiencies: deficiency in design and deficiency in operations:

"Deficiency in design exists when a control necessary to meet control objectives is missing or the control exists but is not properly designed."\textsuperscript{53}

"Deficiency in operations exists when a properly designed control does not operate as designed or when the person performing the design does not possess the necessary authority or qualifications to perform the control effectively."\textsuperscript{54}

Indeed, managers have to establish effective controls in their companies to secure that transactions registered in financial statements are registered as the right amount. Thus a deficiency can signify that management has not been able to secure a process by creating the right control for this process.

A deficiency will not always mean a risk of material misstatements in financial reports as there are different levels of deficiencies:

- Inconsequential
- Significant
- Material

Paragraphs 9 and 10 of the AS.2 the PCAOB define significant deficiency and material

\textsuperscript{51} Sarbanes-Oxley Act section 404, Practical guidance for management, Price Waterhouse Coopers, July 2004
\textsuperscript{52} http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx
\textsuperscript{53} http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx
\textsuperscript{54} http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx
weaknesses in the control system.\textsuperscript{55}

A \textbf{significant deficiency} “is thus a control deficiency or combination of control deficiencies that adversely affect the company’s ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles, such that there is more than a remote likelihood” (that is to say a probable or more than possible likelihood) “that a misstatement of the company’s annual or interim financial statements is more than inconsequential” (that is to say that the misstatements could lead users of financial reports to take decisions they would not have taken if the information given was different) “will not be prevented or detected.”\textsuperscript{56}

A \textbf{material weakness} is defined as “a significant deficiency or combination of significant deficiencies that result in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.”\textsuperscript{57}

The standard adds that the auditor will have to decide if the control deficiency should be seen as a significant deficiency or as a material weakness. Moreover, “the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.”\textsuperscript{58}

One of the objectives of the Sarbanes-Oxley act is to reduce material misstatements through internal control. This third part will briefly present the Sarbanes-Oxley act.

\textbf{3.3/. Sarbanes-Oxley}

\textbf{3.3.1/. General presentation of the law}

In order to regulate accounting and auditing practices, the United States House of Representatives and later the Senate approved the Public Accounting Reform and Investor Protector Act for publicly traded companies. This Act has been voted into law, referred to as the Sarbanes-Oxley Act. It aims at creating a positive environment in publicly traded companies to improve financial statements fairness, transparency, management accountability, and to restore the confidence of the investors. \textsuperscript{59}

Sarbanes-Oxley has introduced a change in the process concerning the issuance of external auditing standards, and the review of the assessment of the performance of external auditors. Moreover, it gave new responsibilities to the senior executives of companies and board members. A main issue of the law concerning auditing is the

\textsuperscript{55} http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx
\textsuperscript{56} http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx
\textsuperscript{57} http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx
\textsuperscript{58} http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx
\textsuperscript{59} Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004, p318
independence of external auditors. Now, the presence of external auditors in the internal control process of the company is forbidden.\textsuperscript{60}

A major part of Sarbanes-Oxley is the creation of an independent institution. The Public Corporations Accounting Oversight Board (PCAOB) is an “independent authority responsible to the SEC that regulates the public accounting profession and sets financial auditing standards\textsuperscript{61}”. This institution will provide auditing standards, and is responsible for monitoring external auditors’ ethics and performance.

All the companies listed on the Stock Exchange in the United States of America have to comply with SOX, regardless of whether they are American or foreign companies. The only criterion is to issue securities on the American capital markets.

In order to be listed, the criteria to follow are defined by the Securities and Exchange Commission, and in particular in the Securities Act of 1933. It states “in general, securities sold in the US have to be registered”\textsuperscript{62}. Companies then have to file a registration form, which calls for “a description of the company’s properties and business; a description of the security to be offered for sale; information about the management of the company; and financial statements certified by independent accountants”\textsuperscript{63}. There are specific exemptions for some cases, described by the SEC, especially for small offerings.

Sarbanes-Oxley is constructed with nine main parts about specific subjects. For instance, the fourth one is titled “Enhanced financial disclosures”. All these sections deal with specific elements of Sarbanes-Oxley. This law will have an impact on the different levels of auditing, corporate governance and financial accounting. We will focus on the auditing part, and the internal control task of each company. Sarbanes-Oxley provides information about internal control in a specific section: section 404.\textsuperscript{64}

\textsuperscript{60} Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004, p317-319
\textsuperscript{61} Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004, p319
\textsuperscript{62} http://www.sec.gov/about/laws.shtml
\textsuperscript{63} http://www.sec.gov/about/laws.shtml
\textsuperscript{64} Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004, p12-13
Figure 2: General presentation of SOX

From a French document of Price Waterhouse Coopers
3.3.2/. Section 404

Sarbanes-Oxley requires that each annual report contain an internal control report that states the responsibilities of the management in establishing and maintaining an efficient internal control system. This information concerning internal control is recognized as the Section 404 rules. It is important, first of all, to redefine internal control in order to be totally conscious of what we are talking about when referring to section 404 of Sarbanes-Oxley.

3.3.2.a/. Internal control definition

A common definition of internal control is:

“Internal control” comprises the plan of organization and all of the coordinate methods adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition recognizes that a system of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments.  

This definition actually means that a process or system has good internal control if it:
- Accomplishes its stated mission
- Produces accurate and reliable data
- Complies with applicable laws and organizations policies
- Provides for economical and efficient uses of resources
- Provides for appropriate safeguarding of assets

Internal control has some objectives to achieve, and has to provide reasonable assurance regarding this achievement of:

- **Effectiveness and efficiency of operations.** This first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources.
- **Reliability of financial reporting.** The second relates to the preparation of reliable published financial statements and selected financial data derived from such statements, such as earnings releases, reported publicly.
- **Compliance with applicable laws and regulations.** The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

3.3.2.b/. Section 404 overview

Section 404 of the Sarbanes-Oxley law deals with internal control. It requires that the SEC develop some rules concerning the management's assessment of internal control over financial reporting. The SEC proposed these rules in 2003, followed by the Auditing Standard 2 of the Public Company Accounting Oversight Board, which will be analysed in more detail later.

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67 Sarbanes-Oxley section 404: a guide for management by internal control practitioners, Professional guidance, the Institute of Internal Auditors, at www.theiia.org, p. 13
These rules require that:

- Management perform a formal assessment of its control over financial reporting, including testing to confirm both the design and operating effectiveness of the controls
- Management includes in its annual report on Form 10-K an assessment of internal control over financial reporting
- The external auditor provides three opinions as part of a single integrated audit of the company, instead of one previously provided. This includes:
  - An opinion on management’s assessment
  - An independent opinion on the effectiveness of the system of internal control financial reporting
  - The traditional opinion on the financial statements

The section 404 of Sarbanes-Oxley requires that an internal control report is done as part of the financial reporting required by the Security and Exchange Commission (SEC), which shall:

1. “State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting
2. Contain an assessment, as the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.”

The management, therefore, now is required to establish a report on the quality of its internal control process. The management is now responsible for the picture drawn by the internal control procedures and testing of the processes of the company, and attest that it is good and done efficiently and in the correct way.

3.3.2. Compliance with section 404

Compliance with section 404 can be difficult for companies, and will require a lot of resources, time and effort. The internal audit and risk management consulting firm Protiviti has suggested a specific approach to comply with Sarbanes-Oxley section 404: it is to launch a specific project about compliance, following the next steps:

1. Organize section 404 compliance project approach: assign a project to a team, and estimate all the resources, time, costs, staff
2. Develop a project plan: the team has to develop a project plan, with precise steps to begin the internal control processes review.
3. Identify, document and test key internal controls
4. Review compliance results with key stakeholders: the management will be responsible for the internal control processes, and so it is important to assess the

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68 Sarbanes-Oxley section 404: A guide for management by internal control practitioners, The Institute of Internal Auditors, Professional guidance, at www.theiia.org p. 11
compliance mechanism regularly.

5. Complete a report on the effectiveness of the internal control structure: it is the final step towards compliance with section 404.

In order to comply efficiently with section 404 of Sarbanes-Oxley, there are several steps to take into consideration:

1. Assemble review team, including sponsor and other review members, including internal audit.
2. Define project objectives.
   a. Determine if review will cover just financial controls or efficiency and effectiveness areas as well.
   b. Determine organizational units to be covered in review
   c. Review results from any previous Section 404 or internal audit reviews requiring follow-up
   d. Establish project time line that allows time for external audit review
   e. Review planned objectives with CFO and audit committee
3. Develop detailed project plan covering processes to be reviewed.
4. Establish review approach for each process/system included in review.
   a. Define nature and types of possible errors and omissions
   b. Define nature, size and composition of transactions to be reviewed
   c. Determine volume, size, complexity and homogeneity of individual transaction processed
   d. Establish guidelines for materiality and error significance
   e. Understand process transaction susceptibility to errors or omissions
5. Review approach and timing with external auditors.
6. Establish standards for review of documentation and project progress reporting.
7. Complete preliminary reviews for each identified process or system.
8. Follow up and resolve any items requiring investigation.
9. Consolidate review work and prepare preliminary 404 report.
10. Review 404 report’s results with CFO and release report.

Figure 3: Section 404 Compliance Review Breakdown Structure

There are different planning considerations to take into consideration when complying with SOX:

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71 Sarbanes-Oxley and the new internal auditing rules, Robert R. Moeller, p108
Figure 4: Planning Considerations for Section 404 Compliance Audit

- Select the priority accounts and disclosures
- Consider significance to financial reporting and risk of misstatement

- Document the transactions flows that materially impact the priority financial reporting elements

- Use financial reporting assertions to source what can go wrong within the processes

- Document entity controls
- Document the controls at the source of the risk (preventive) or downstream in the process (detective)

- Assess effectiveness of controls design at entity and process levels

- Assess effectiveness of controls design at entity and process levels

Select Priority Elements

Document Processes

Source Risk

Document Controls

Assess Design

Validate Operation

Report

Conclude Disclose Report
3.4/. An internal control framework: the COSO Model

3.4.1/. The PCAOB and its Auditing Standards

A responsibility of the Public Company Accounting Oversight Board, created with SOX, is to provide auditing standards. There are four standards, concerning different issues:

- Auditing Standard 1: References in Auditors' Report to the Standards of the Public Company Accounting Oversight Board

- Auditing Standard 2: An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements

- Auditing Standard 3: Audit Documentation

- Auditing Standard 4: Reporting on Whether a Previously Reported Material Weakness Continues to Exist

In relation to our research question, we are particularly interested in Auditing Standard 2 and its implications in terms of internal control for the companies. Management actions are driven by the Securities and Exchange Commission (SEC) and not the PCAOB, but Auditing Standard 2 was approved by the Securities and Exchanges Commission in June 2004, and is effective with the requirements of Sarbanes-Oxley section 404 in terms of audits of internal control over financial reporting. It is a standard for external auditors and only mandatory for them, and not for the management of a company.

It is now important to differentiate more precisely between internal control and internal control over financial reporting, the one considered by Sarbanes-Oxley.

3.4.1.a/. Internal control over financial reporting

In order to assess the management, and to audit internal control over financial reporting in this standard, internal control over financial reporting is defined in the report on this standard by the PCAOB as:

"A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

1. Pertain to the maintenance of records that, in reasonable detail, accurately and
fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.  

Therefore, internal control over financial reporting is a specific part of the internal control process and is particularly related to the financial statements of a company. It considers elements such as their construction, the information it contains, and the way it is presented explained and so on. This definition is the same as the one given by the SEC, with the exception that the word "registrant" is replaced with "company", more suitable from the PCAOB perspective.

On May 16, 2005, the SEC issued a "Statement on Management's Report on Internal Control over Financial Reporting" saying that:

"An overall purpose of internal control over financial reporting is to foster the preparation of reliable financial statements. Reliable financial statements must be materially accurate. Therefore, a central purpose of the assessment of internal control over financial reporting is to identify material weaknesses that have, as indicated by their very definition, more than a remote likelihood of leading to a material misstatement in the financial statements. While identifying control deficiencies and significant deficiencies represents an important component of management's assessment, the overall focus of internal control reporting should be on those items that could result in material errors in the financial statements."  

3.4.1.b/. Limitations inherent to internal control over financial reporting

Internal control over financial reporting is a process aimed at preventing accounting fraud by verifying all the steps of the establishment of fair and correct financial statements. As such, it provides a reasonable assurance that a company will achieve its financial reporting objectives, but not an absolute one. Indeed, there are inherent limitations within this process such as:

- Human error: when employing human resources, there is always a risk of poor decisions, of an error or a mistake by people with an active role in the process
- Management override: even if the control process is efficient in a company, managers can always find a way to override internal control processes for illegitimate purposes
- Collusions: there can be collusions between two or more people to circumvent

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79 Sarbanes-Oxley section 404: a guide for management by internal control practitioners, the Institute of Internal Accountants, www.theiia.org, Professional guidance p7
what would have been efficient control

Because of these inherent limitations, there is the risk that material misstatement may not be prevented or detected in time, by the team responsible for Internal Control over Financial Reporting. But these risks are known, and there are ways to minimize them.

This Auditing Standard 2 gives all the information required to proceed with an efficient and correct auditing. In this perspective, it gives more accurate elements related to the framework management should use to conduct its assessment.

3.4.2/. Framework for assessment by the management under Auditing Standard 2

3.4.2.a/. Requirements

The Public Company Accounting Oversight Board gives a clear definition of what is required of the management in terms of internal control over financial statements. Indeed, it is stated in the Bylaws and rules report that "management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures, including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;
- Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;
- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal control over financial reporting are not omitted; and
- Is relevant to an evaluation of internal control over financial reporting."

The PCAOB and the SEC recognizes that the most suitable system for responding to all these demands is the COSO model, which was already widely used all around the world before Sarbanes-Oxley. An understanding of the COSO model is necessary and essential in understanding the requirements of section 404 of Sarbanes-Oxley in terms of internal control.

3.4.2.b/. COSO

In 1985, the Committee of Sponsoring Organizations of the Treadway Commission was formed in order to sponsor the National Commission on Fraudulent Reporting. The goal of that entity was to identify, study, and report on the factors that can lead to a

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82 Sarbanes-Oxley section 404: a guide for management by internal controls practitioners, professional guidance, The institute of internal auditors, at www.theiia.org, p. 16
fraudulent financial reporting situation. From the beginning, COSO aimed at improving the quality of financial reporting, and to develop efficient voluntarily guidance in terms of internal control. Therefore, in 1992, COSO published *Internal control-Integrated Framework* that provided an internal control framework and some evaluation tools and procedures that could be used by organizations in order to evaluate their control systems. It is important to notice that COSO defines internal control as a process, built on the overall business processes of an organization.  

Concerning the three objectives of internal control identified earlier the COSO perspective on Internal Control over Financial Reporting does not, generally speaking, include the first and third objectives of efficiency and effectiveness of operations, and compliance with laws and regulations. However, the control designed and implemented by the management can achieve more than one objective. Moreover, these two objectives directly relate to the presentation of and the disclosure in financial statements, and are therefore included in internal control over financial reporting according to the PCAOB.  

The COSO framework describes internal control as five interrelated components:

- **Control environment**

This is the foundation for the other components of internal control, and provides discipline and structure. The control environment is emphasized by COSO as having a pervasive influence on the structure of the business and the assessment of the risks within the organization. It reflects the attitudes, actions and awareness of the management within a company. There are major elements of the control environment that can be looked at in more detail:

  - Control environment: Integrity and ethical values.

These are essential elements of the control environment. The COSO model emphasizes that the values and policies of a company have to be communicated at all levels of the organization. If the company presents a strong moral message, this will be a motivation for people to act correctly. In order to describe these ethical values, and the rules for ethical behaviour, the company should have a clear code of conduct, which should be presented to everyone and understandable by everyone.

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Sarbanes-Oxley section 404: A guide for management by internal control practitioners, The Institute of Internal Auditors, p16-17  
COSO Description, Proviti KnowledgLeader, http://knowledgleader.com  
Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004  
Sarbanes-Oxley section 404: A guide for management by internal control practitioners, The Institute of Internal Auditors, p16-17  
COSO Description, Proviti KnowledgLeader, http://knowledgleader.com  
Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004
Theoretical framework

- **Control environment: Commitment to competence.**
  
  Sometimes, the company can suffer from a lack of competences, of job skills from its employees, and this will affect the control environment. As a result assessment of competences within company personnel is an important task, even if it is a difficult one. COSO advocates that adequate supervision and training be available for staff to help them acquire and develop the required skills to perform their job efficiently.

- **Control environment: Board of directors and Audit committee.**
  
  The control environment is strongly influenced by the actions of these two entities. Before Sarbanes-Oxley, the Board of Directors was not totally independent from management, and this could affect the control environment. However, with Sarbanes-Oxley, independence has become a golden rule, and so the situation has changed. Indeed, the Board of directors currently has a more important role concerning corporate governance, and the Audit committee is composed of independent outside directors.

- **Control environment: Management's philosophy and operating style.**
  
  The way managers behave can strongly influence the control environment. Indeed, some of them can be used to taking significant risks, while others would be very cautious or conservative. So these elements are important to take into consideration in terms of the control environment.

- **Control environment: Organization Structure.**
  
  This component of the control environment “provides a framework for planning, executing, controlling and monitoring activities for achieving objectives.” This relates to the way all the functions within the organizations are organised and managed: it can be centralized or decentralized. It is important for the employees to understand the total goals and objectives of the group they are a part of; otherwise there could be significant weaknesses in terms of control.

- **Control environment: Assignment of Authority and Responsibility.**
  
  This is essentially the way function and responsibilities are defined. This assignment of responsibilities is often linked with avoiding conflicts and confusion. The COSO framework defines it as a very important part of the control environment as: "the control environment is greatly influenced by the extent to which individuals recognize they will be held accountable. This holds true all the way to the chief executive, who has ultimate responsibility for all activities within an entity, including internal control systems."

- **Control environment: Human Resources Policies and Practices.**
  
  Human Resources functions should be very clear regarding their policies and practices. The employees should be informed of them. The areas where these policies and practices are particularly important are: recruitment and hiring; new employee orientation; evaluation, promotion, and compensation; disciplinary actions.
Theoretical framework

- **Risk assessment**<sup>87</sup>

The organization must be aware of the internal and external risks it faces that can jeopardize the success of the objectives, and has to deal with them. First of all, it has to identify the objectives.

Then, in order to assess the risk efficiently, at all stages and in all activities, the COSO advocates a three-step process:

- Estimate the significance of the risk
- Assess the likelihood or frequency of the risk occurring
- Consider how the risk should be managed, and assess what actions must be taken.

This risk assessment is the responsibility of the management. COSO emphasizes that risk analysis in itself is not a theoretical process, but it is critical for the overall success of a company. COSO has published the "Enterprise Risk Model Framework" as a precise guidance for this evaluation of the risks.

- **Control activities**<sup>88</sup>

These control activities consist of the policies and procedures designed to help ensure that the managers' directives related to risk management are respected. Control activities occur at all levels of an organization, and in all its functions. Control activities should be related to the identified risks discussed as a part of the risk assessment element of the COSO model. The emphasis is given to the fact that control procedures are needed at all significant information levels: financial, operational and compliance-related stages. COSO suggests a list of some control activities such as:

- Top-level reviews: the managers at the different stages should analyse the results of their activities
- Direct Functional or Activity Management: this part concerns the analysis of the reports from the control systems, and takes the appropriate corrective actions
- Information Processing: the information system contains controls to check compliance and report the exceptions it states, and corrective actions have to be taken

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*Sarbanes-Oxley section 404: A guide for management by internal control practitioners*, The Institute of Internal Auditors, p16-17

*Sarbanes-Oxley section 404: A guide for management by internal control practitioners*, The Institute of Internal Auditors, p16-17

COSO Description, Proviti KnowledgLeader, http://knowledgleader.com
Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004
Theoretical framework

- Physical Controls: this relates to the need for appropriate controls over physical assets (periodic physical inventories)

- Performance Indicators: this is linked with the analysis of financial and operational data

• Information and communications

Information and communication systems, including the accounting system, enable the actors of an organization to identify and exchange the information needed to conduct, manage and control the operations of that company. It is important that this information and communication takes place in the entity as a whole, internally and externally speaking. The communication has to be effective within the company, but also externally with actors such as shareholders, customers, and suppliers... Information and communication are related, but very distinct components of internal control.

  o Quality of information.

With poor quality information, some mistakes can be made, or the ability of manager to take the appropriate decisions can be affected. Therefore, the quality of information concept requires that:

- The content of reported information is appropriate
- The information is timely and available when required
- The information is current or at least the latest available
- The data and information are correct
- The information is accessible to appropriate parties

  o Effectiveness of communication.

The existence of efficient communication channels, internally and externally, is an important element of the framework of internal control. COSO summarizes this element of internal control as: "an entity with a long and rich history of operating with integrity, and whose culture is well understood by people through the organization, will likely find little difficulty in communicating its message. An entity without such a tradition will likely need to put more into the way the messages are communicated."

89 Michael Ramos, How to comply with Sarbanes-Oxley section 404, Assessing the effectiveness of internal control, Wiley, second edition, New York, 2004p.40
Sarbanes-Oxley section 404: A guide for management by internal control practitioners, The Institute of Internal Auditors, p16-17
COSO Description, Proviti KnowledgLeader, http://knowledgleader.com
Robert R. Moeller, Sarbanes-Oxley and the new internal auditing rules, Wiley, Hoboken, 2004
• Monitoring

The entire control process must be monitored, and the necessary modifications made. In this way, the organization is able to react dynamically. It is important that a process exists to assess the quality of the performance and effectiveness of the system. COSO gives some examples of the ongoing monitoring component of internal control:

- Operating management normal functions
- Communications from external parties
- Organizational structure and supervisory activities
- Physical inventories and asset reconciliation

More generally speaking, an activity that reviews all activities on a regular basis and suggests potential corrective actions can be thought of as a monitoring activity.

Figure 5: COSO five layouts description

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92 Price Waterhouse Coopers
However, in practice, the assessment of internal control over financial reporting is conducted at two levels instead of the five presented above. Generally speaking, most of the controls that are assessed are those found in the Control Activities part of the model. Controls as a part of the other four layers are generally grouped together and recognized as entity-level controls.

Particular attention has to be given to these entity-level controls, even if most of the controls are a part of the Control Activities layer, because:

- "These controls are presumed to have a pervasive effect on the activities of the entire company

- Many of the control deficiencies underlying the public accounting issues of the last several years -including Enron and WorldCom- were in these areas."93

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93 Sarbanes-Oxley and the section 404: a guide for management by internal control practitioners, professional guidance, The institute of internal auditors, o www.theiia.org, p. 17
CHAPTER 4: EMPIRICAL FINDINGS

In this chapter, the data we gathered from the interviews are presented separately, and then compared in a table to identify the most interesting findings.

4.1/. Findings from the first company

4.1.2/. General background of the company

The first company we interviewed was SKF in Sweden. SKF was founded at the beginning of the twentieth century, and experienced rapid economic growth. It develops its international dimension at an early stage, being established on every continent by around 1920. Nowadays, the company is present in more than 130 countries, with more than 100 manufacturing sites all around the world, selling to approximately two million customers.\(^9^4\)

SKF is operating on a global level. It is the first supplier of products, solutions and services in the different markets of rolling bearings, seals, mechatronics, services and lubrications systems. SKF is divided into three main areas: Automobile, Services and Industrial.\(^9^5\)

Concerning the financial perspective of the company, here is an overview of the major significant financial figures of the group:

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales, MSEK</td>
<td>53,101</td>
<td>49,285</td>
<td>44,826</td>
</tr>
<tr>
<td>Operating profit, MSEK</td>
<td>6,707</td>
<td>5,327</td>
<td>4,434</td>
</tr>
<tr>
<td>Profit before taxes, MSEK</td>
<td>6,387</td>
<td>5,253</td>
<td>4,087</td>
</tr>
<tr>
<td>Basic earnings per share, SEK</td>
<td>9.48</td>
<td>7.73</td>
<td>6.42</td>
</tr>
<tr>
<td>Diluted earnings per share, SEK</td>
<td>9.45</td>
<td>7.70</td>
<td>6.42</td>
</tr>
<tr>
<td>Dividend per share, SEK</td>
<td>4.50(^1))</td>
<td>4.00</td>
<td>3.00</td>
</tr>
<tr>
<td>Cash flow after investments, MSEK</td>
<td>3,003</td>
<td>429(^2))</td>
<td>1,900(^2))</td>
</tr>
<tr>
<td>Return on capital employed, %</td>
<td>24.7</td>
<td>21.8</td>
<td>19.0</td>
</tr>
<tr>
<td>Gearing, %</td>
<td>39.1</td>
<td>33.2</td>
<td>24.9</td>
</tr>
<tr>
<td>Equity/assets ratio, %</td>
<td>42.4</td>
<td>45.2</td>
<td>49.3</td>
</tr>
<tr>
<td>Additions to PPE, MSEK</td>
<td>1,933</td>
<td>1,623</td>
<td>1,401</td>
</tr>
<tr>
<td>Registered number of employees, 31 Dec</td>
<td>41,090</td>
<td>38,748</td>
<td>39,867</td>
</tr>
</tbody>
</table>

Number of shares 31 December 2006: 455,351,068 whereof A shares: 49,533,030, B shares: 405,818,038
1) Dividend according to the Board’s proposed distribution of surplus
2) Have been recalculated due to restatement of cash flow

Table 2: Financial figures SKF\(^9^6\)

\(^9^4\) Information on: http://investors.skf.com/annual2006en/20070319/?mode=100&page=19
\(^9^6\) http://investors.skf.com/annual2006en/20070319/?mode=100&page=19
SKF went public in 1914 on the Stockholm Stock Exchange. Nowadays, SKF B shares are registered with the Securities and Exchange Commission, and SKF’s ADRs (American Depository Receipts) are traded on the OTC (Over The Counter) market in the United States. It is interesting to have a quick overview of the geographical ownership of these shares, given the focus of our report:

![Geographical ownership](http://investors.skf.com/annual2006en/20070319/?mode=100&page=19)

**Figure 6: Geographical ownership**

Regarding the corporate governance of the company, according to their 2006 report, SKF applies “the principles of safe corporate governance as an instrument for increased competitiveness and to promote capital market confidence in SKF”\(^\text{98}\). SKF respects the Swedish Code of Corporate Governance, but also has to comply with the requirements of the American law Sarbanes-Oxley.

### 4.1.2. The interviewee

At SKF, we were able to interview Anders Widegren. He has been working at SKF since 1988. Before joining the audit group, he worked in various controller and finance functions within the corporate group.

He works in the Group Audit department together with three other internal auditors plus two administrators. As it is a small team, all the auditors have to deal with all the types of auditing questions. During the last two years, they have been busy dealing with the implementation of SOX (Sarbanes-Oxley).

Within the SOX project, he has been responsible for the so called Entity Level Controls. The Entity Level Controls are controls referring to a whole unit of the company, and covers areas such as policy issues, or organization policies. His responsibility is related to questions that refer to the whole company, and not specifically to a certain type of transaction control.

### 4.1.3. Findings

**4.1.3.a/. Consequences of the implementation of section 404 of SOX**


- **Reasons for implementing SOX**

SKF was earlier listed on the NASDAQ, de-listed in 2005, but is still on the OTC market in the United States. They also have loans, bonds outstanding on the American market and are therefore required to provide the US Security and Exchange Commission with a “Form 20-F” report (annual report). That is why they have to comply with SOX.

- **Implementation process**

The implementation of SOX has been centrally coordinated and monitored by the internal audit department. They started work on the project in 2003, after which a number of people were hired, and the real work took place in 2004 to 2006. Originally, the project should have been finished by 2005, but since they are a foreign company, they got an extension thanks to new rules. As such the project had to be concluded by the end of fiscal year 2006. This means that this year is going to be the first year they really report on SOX.

However, they are now in the process of investigating if it is possible for them to deregister from the SEC requirements, meaning that they will try to avoid the requirements imposed by SOX. It appears that they could be successful. All the processes are, however, now in place, and all the work has been completed in order to comply with SOX requirements. If they deregister, they will keep some of the processes, but without being subject to SOX requirements in the future.

If SKF ceases to be dependent on SOX, they can run their internal control administration as they find it useful for the company, and they are not only limited to SOX requirements. It is not because they think that it is not a good idea to have these requirements in place, and they will keep using all the controls. They will limit the testing part, which is very costly and time-consuming. In particular, they will keep the standards of the COSO model and perform them in a less bureaucratic way. Hence, they would like to do it on a more risk-based approach, relying on the most significant controls.

To return more specifically to the organization of the implementation of SOX in the company, Anders Widegren detailed the following levels:

- **The organization level:**

  First, they have a steering committee consisting of the Group CFO, the Legal Counsel, the divisional controllers and the different people who are connected to the SOX project.

  Next, they have the central project team (essentially the group audit), which coordinates the work for the group.

  Next, they have the SOX coordinators in the different companies that is to say, one SOX coordinator for a subsidiary. Their role is to coordinate the work in the respective companies.

- **The operation level:**

  At the operation level, there are the processes on the control owners. Therefore, there
Empirical Findings

are the people who are actually responsible for certain processes, such as accounts payable, payrolls and so on. There are also the individual control owners, responsible for making sure that the controls are well described and performed in the companies.

The project is divided into three different main components:

- Entity Level Controls (ELC)
- Transaction Level Controls (TLC)
- Information Technologies Controls (IT)

These components are different inter-related subprojects, and are run in parallel. From an IT perspective, they use a risk navigator; software used especially for SOX and risk assessment processes. This is necessary given that they have 40 units in scope and some 3 to 4,000 controls in the finance areas, which represent a lot of controls and administration.

At the beginning, there was a lot of information and the first stage of the project was to go to the different companies, and explain what SOX was and what was going to be done. In addition, there was a homepage where the information could be found. After that, the companies had to provide evidence for the controls and so on. When this was done, they used Ernst&Young as a consultant to perform the management testing. Management testing is a long process; it is a pre-test of the controls. Following this, KPMG, their external auditors, performed the audit on various controls that they selected from various units. These are the basic steps they used to perform the implementation of SOX properly.

- Changes due to the implementation of SOX within the company

It appears that the changes due to the implementation of SOX within the company resulted in an improvement in internal control in general, with it becoming more rigid, therefore stricter and more formalized. Although the controls existed before, they were not documented. Therefore, internal control has become a more solid and a more robust system.

Generally speaking, there has been an improvement in internal control as a whole. The management of the company has become more aware of the forms of controls, and of the importance of internal controls. There is also more awareness of group policies. Moreover, the concept of segregation of duties, which is a central part of the internal control area, has become more accepted. Concerning models of internal control, they were using the COSO framework before the implementation of Sarbanes-Oxley, but without being really aware that they were doing so. Now, they are doing it more explicitly, due to SOX.

However, there were also some costs and time issues. It costs a lot of money to implement SOX, and requires a lot of internal resources. It is difficult to define the exact cost of the implementation, but all the costs combined would amount to over one hundred million Swedish crowns. It should be stressed that this is not an exact figure, given that it is very difficult to assess exactly what resources are involved in the process, in which part, whether it is only because of SOX and so on. This hundred
40 million refers mainly to section 404.

Even if a new service has not been created to manage the implementation of SOX, the group in charge of the project has grown. Before SOX, the internal audit department was very small, consisting of just one person. Although it is still not a big department there are now six people, mainly because of the SOX project.

4.1.3.b. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements

The company has never had any case of serious errors where they have had to do changes to the financial statements. As such they did not notice any significant changes with SOX. Maybe in some countries, fewer auditing comments have been seen during the regular financial audit than previously. In SKF, there have been fewer observations than they had previously, but it is difficult to analyse how much this is dependent on SOX, and how much it is dependent on general improvements by the company. However there is a general feeling that SOX could have had a positive impact.

The respondent has not noticed much change in the financial statements. Regarding disclosure, (that which is actually disclosed in the financial reports), there are certain items that come directly from SOX, such as the actual certificate for 404. Otherwise, there is not so much about disclosure in SOX. This comes mainly from accounting standards, such as US GAAP requirements and IFRS. Therefore, SOX has brought changes into the controls for producing the financial statements, but it has not really affected the content of the financial statements themselves.

Auditors can also have a role in the implementation process of SOX. At SKF the external auditors were already independent auditors, and they are not involved in the implementation as they are not allowed to be. The external auditors can have a discussion with the managers of the company, but the auditors cannot be involved in the process. Therefore their role has been to perform the external audit of SOX controls. As a result there is a very clear distinction between the management testing, which was performed by Ernst and Young, and the external auditors who are KPMG. Ernst&Young auditors worked with SKF as their advisors in the implementation process, and there was no independency issue with them, unlike with the external auditors who must be independent according to SOX legislation.

Regarding the role of the auditors, the concept of integrated auditors (they perform the audit of financial statements integrating the audit of internal control) has not been fully implemented yet, but will probably happen in the future. So far, the financial audit and the SOX audit have been two different procedures. The PCAOB stated recommendations that there should be an integrated audit, but it will probably occur in the future when the auditors have gained more experience. However the auditors have become much more careful to preserve the independence required by SOX.

4.1.3.c. SOX and the European and national perspective

Initially, the reaction to SOX to say the least was far from enthusiastic. There was also a strong reaction in the United States. People thought it was way far too time-consuming and costly, and the amount of control was overwhelming, making it an administrative nightmare. The idea behind SOX is fine, but the way it was interpreted by the PCAOB was not so good, especially in the beginning. When SKF members of the SOX project
Empirical Findings

met with other companies implementing SOX in Sweden, every representative of the companies thought that SOX was effectively an over-reaction: too detailed, too much testing, just too much...

In the SKF group, the initial reaction to SOX was very negative; based on what they would have to do. However, opinion has changed, and today people are more favourable towards SOX, and say that it is not a good idea to take it away because there are controls in place and it works. As such, the point of view has changed during the process, and people are more favourable to the idea of better internal control. Moreover, people are also favourable to the COSO standards.

Regarding other legislation, at the European or Swedish level, there is no significant impact on their company. The Swedish Corporate Governance Code is very light compared to SOX, so it does not have a real influence, meaning that if a company is engaged in the SOX process, other legislation is relatively insignificant in terms of workload. Things could, however, change in the future. For SKF, SOX has been the most significant legislation so far. But the respondent thinks it is likely that something is going to happen on a European level. This may or may not be based on the COSO model, but hopefully will not be as bureaucratic as SOX, and more practical. But that is likely to happen, both in Sweden and in Europe because there is a need to strengthen internal control within companies.

4.1.3.d. Global assessment

SKF members of the SOX project were sometimes surprised when doing testing, because basic things that they expected to be implemented were actually not there. To give an example, they thought it was basic and fundamental to have an authorization policy, yet when they performed the testing they realized that in some of the units there was no such documented policy. They had not anticipated finding deficiencies in aspects that were considered as fundamental.

It was also surprising to see the evolution of companies in relation to SOX. Some companies that were very negative to SOX changed their opinion considerably, and late in the process became rather “pro-SOX”.

In addition there was further surprise at the amount of work and time involved. The managers of the company knew it would be a time-consuming project, but it was even more time-consuming than they expected.

Now, the managers of the company are happy with the idea of SOX, and especially with COSO. COSO is regarded as a very good framework, and they will keep it implemented even if they move away from SOX. However the SOX approach is regarded in a negative light, because of the huge amount of testing involved and too much concentration on small details. It is felt by the respondent that there should be more emphasis and controls on major issues such as policies, the role of the audit committee, governance issues etc.

Regarding SKF, the respondent thinks that the project was run efficiently, members of the SOX project were able to keep to all their time deadlines, and got the final acceptance on the project from the auditors, they had no material weaknesses etc. As a result the effect of the project was positive.
Currently, SKF managers are reviewing the controls to see if some of them can be taken away, and others introduced. Reviewing all the controls and assessing which ones are more important from a risk-based perspective is something that will be done on a regular basis.

However, the respondent would not recommend other companies to voluntarily attempt to meet the SOX requirements, but he would recommend using COSO for the aspects of internal control.

4.2/. Findings from the second company

4.2.1/. General background of the company

Concordia bus is one of the top ten European public transportation groups, and operates principally in the Nordic bus transportation market. The company carries around 280 million passengers each year through its three business lines: Public Bus Transport, Express Bus services and Coach Hire. The company is the result of different strategic options faced by a Norwegian bus operator who had the will to build a European bus transportation company in the 1920’s.99.

Here is a table to briefly summarize Concordia bus financially:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue</td>
<td>5075</td>
<td>4683</td>
</tr>
<tr>
<td>Operating income</td>
<td>-24</td>
<td>-344</td>
</tr>
<tr>
<td>Income after non financial items</td>
<td>-246</td>
<td>-794</td>
</tr>
<tr>
<td>Restructuring costs</td>
<td>-</td>
<td>-162</td>
</tr>
<tr>
<td>Income after tax</td>
<td>-245</td>
<td>-795</td>
</tr>
<tr>
<td>Cash flow for the year</td>
<td>117</td>
<td>2</td>
</tr>
<tr>
<td>Cash and Cash equivalents including restricted funds at the end of the year</td>
<td>351</td>
<td>231</td>
</tr>
<tr>
<td>Equity/Asset ratio%</td>
<td>6,7</td>
<td>-0,6</td>
</tr>
<tr>
<td>Shareholders equity at the end of the year</td>
<td>227</td>
<td>-17</td>
</tr>
<tr>
<td>Shareholders equity at the end of the year (ordinary shares in SEK)</td>
<td>11,35</td>
<td>-0,85</td>
</tr>
</tbody>
</table>

In millions of SEK, using IFRS standards.

Table 3: Key financial figures for Concordia bus100

In 2000 Concordia bus acquired the Swebus group. The acquisition was financed through SEK 630 million in cash and a bond loan of 100 million euros for Concordia bus.

In 2002 the bond loan was increased to 160 million euros.

99 www.concordiabus.com
100 From Concordia financial report 2006, on www.concordia.com
In 2005 the loan was converted into shares and the holders of the loan assumed ownership at 97.5% of the share in Concordia bus. At the same time another 45 million euros loan agreement was signed, and in 2007 an outstanding amount of this loan was repaid thanks to the issuance of new shares in Concordia bus.

### 4.2.2/. The interviewee

The respondent Annika Kolmert is the SOX Project Manager at Concordia Bus and she is responsible for coordinating all main processes in Concordia bus subsidiaries. Her role is more or less a coordinating role that is not focused only on internal audit or on finance areas but also on qualitative issues and methodology regarding how to implement effective processes within the company. She is in charge of different areas within the company.

At first she was recruited especially for the implementation of SOX within the company. However the managers of the company had the view that the SOX project role could also be developed with a wider focus on all processes, not only on the finance area of the company. As a result she is now in charge of implementing different processes within the company.

The Concordia bus SOX project started in March 2005, and lasted nine months. During these nine months the company determined what they would have to do to implement SOX efficiently. According to the respondent, Mrs Kolmert, it has almost been three years and Concordia is still in the implementation process and is just starting to be able to work with SOX on a continuous basis, due to the fact that the implementation of SOX takes a considerable time regardless of the size of the company.

### 4.2.3/. Findings

#### 4.2.3.a/. Consequences of the implementation of section 404 of SOX

- **Reasons for implementing SOX**

Concordia bus has to implement the Sarbanes-Oxley Act not because it has some stockholders in the United States of America but because they have debt. More precisely they issued junk bonds, and many of them were bought by people in the United States of America meaning that the company has a lot of American interest. The company should not actually have to comply with SOX because the bonds are not traded in the USA but in Luxembourg. However due to the importance of the American interests within the group the Security and Exchange commission decided that they would have to report to them, and therefore to comply with the Sarbanes-Oxley Act.

The respondent actually said that they would stop reporting to the SEC when the loans are repaid. However the company will definitely keep on using the mechanisms and processes that they had to implement when reporting SOX to the SEC, as the work the company has done regarding Internal Control over Financial Reporting has been greatly appreciated by the owners of the company. The company is planning to use the new systems as long as it can, as many good working practices have been developed and these have helped the company, and especially the finance area, to evolve in a positive way.
• **Implementation process**

Concordiabus’ SOX implementation process has been a very smooth process. It is not a big company with around seven thousands employees, five billion SEK turnover and five subsidiaries. The company’s subsidiaries already had a lot in common such as IT infrastructure, and a small finance department with a common journal ledger for the group and so on.

Concordiabus’ infrastructures were extremely easy to handle and to work with and this facilitated the implementation of SOX. Thus the size of the company was advantageous for the project. The five finance directors and CEOs of the different entities of the company joined together for a workshop of three hours to realize the first risk assessment of the company (see example appendix 5).

Next they analysed the risks to all processes of the company, collected data and figured out who had to check out the risks that management had identified. This was valuable work.

Following this the management had to define the biggest risk for the company, the risks that would have the most important effect on the financial reports. The management decided that there were twelve significant risks, and decided to treat those risks, which means that the scope was focused on the twelve risks. Some check points or controls were created for those risks and the controls had to be implemented. They wrote instructions and policies regarding how to treat those areas, which were the most at risk, and defined the controls to secure that the company would not fail when dealing with those risky areas.

At Concordiabus, many people have been involved in the implementation process of SOX. Among the seven thousand employees in the company, at least three hundred people work in administration and of those three hundred, around eighty-five were involved in the implementation process of SOX. Everybody was aware of what SOX was, lots of training about SOX was given and everybody knew what was going on in the company.

Communication channels worked well, and the project was greatly appreciated by the management because the company focused on risk and particularly on the main risks, rather than on everything, or on many details.

For the respondent the hard part of SOX is now, after the project is over. The company is now trying to keep alive all the work it has done. Employees need to work much more on a daily basis with SOX and that is the main issue for the management now, especially for the finance directors at the headquarter and in the subsidiaries because they need to focus on SOX, Internal Control over Financial Reporting and the new control processes. The local directors are sometimes struggling to stop focusing on profitability analysis and to focus more on SOX, and internal control.

Thus the biggest effort is actually after the project, as there is a need to prove that the project is actually working and the employees have to integrate it into daily business and this is a significant implication of Sarbanes-Oxley; it is harder that the project itself because there is always a conflict between earning money and control. The company now does some monitoring on a regular basis so that the system works and compared to
other companies it has been a very smooth implementation with a focus on principal risks and not on details.

- **Changes due to the implementation of SOX within the company**

The main change at Concordia bus after the implementation of SOX is the focus. The company did not focus on internal control at all before SOX. The company used to focus only on profitability, which meant on a few lines in the Income Statement. Now the company focuses on the Income Statement, the Balance Sheet, and the Cash Flow Statements. The company is now ensuring that the right things are in the financial statements and they are doing it in a different way than prior to SOX.

Concordiabus’ management now plans to focus more on internal control and considerably improve the company’s methods in this area. Although not a significant change for the company, this is what the implementation of SOX has brought. Sarbanes-Oxley forced the companies to consider everything they need to find all the material amounts and any other core amount in the financial reports.

Sarbanes-Oxley is equally beneficial for the management because they have to file the SEC forms and say that the financial reports are true and accurate. The management now feels much calmer and is satisfied with the new procedures, and they feel much more secure when the numbers are arriving.

Regarding the organization of the company there was no significant impact. They merely included the new procedures in the normal working procedures, although it took a long time because many people were involved and they had some long-term habits in their working practice. Producing a policy or instructions was not sufficient, as changes needed to be made at all the levels and people had to accept and understand the new procedures. The changes of procedures were sometimes small changes such as people signing the journal voucher, whereas previously, sometimes only one person or no one at all would sign it. The change had to be implemented because at least two people had to sign it.

Therefore Concordiabus has seen that there were some deficiencies and that it is difficult to introduce new working procedures. In addition introducing new working procedures is not only about giving instructions to one person within a department, as the whole department needs to understand the changes, and the managers of the department need to be reactive.

There was no significant impact in terms of time and cost because the company did not hire many external consultants for the project, rather doing the biggest part of the Sarbanes-Oxley implementation by itself and unique way to implement SOX was used. Indeed, Internal Control over Financial Reporting processes are not only about completing excel sheets; employees have to change working methods in many ways so it is best to avoid external people like consultants. Companies need to make use of their own employees because they are the ones who will have to maintain the system.

The consultants who were hired for the project supported the company’s management with methodology regarding the implementation of SOX. The cost of those consultants was quite low, around seven hundred thousand SEK. The company’s employees spent around one thousand seven hundreds hours working on the SOX and in terms of kronor
Empirical Findings

per hour it would amount approximately two point two million SEK.

Due to Swedish laws Concordia bus had already implemented many aspects of Sarbanes-Oxley. The only significant element that was not in compliance was part 404 with internal control. Concordia bus is implementing 404 throughout the company, even in the small subsidiaries that probably would not be a part of SOX if the company had used the traditional way to implement Sarbanes-Oxley. All the subsidiaries are involved, everyone needs to report SOX internally, because it increases the level of competence in many ways and especially in the finance and control area.

The company did not use the COBIT model for IT control, instead using an English and more standardized European framework for IT infrastructures.

The company used the COSO model to implement SOX. COSO was not used before the SOX law, and the framework has been highly appreciated within the company. Concordia bus considers COSO to be a very useful tool and an excellent model for implementing internal control, and used the framework with a personal interpretation, not on a detailed level but with common sense and good proportion of details. The company’s internal control system was not really developed before SOX, and although there were some attempt of developing of internal control procedures it was not as clear as it is today. Thanks to internal control, the company now has a good over view and better control of what they are doing or not doing.

4.2.3.b/. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements

For the respondent, material errors in financial reports are not reduced by the implementation of section 404 of SOX.

In actual fact, it may be too early to say whether SOX helps to reduce material errors in financial reporting or not. SOX does not change the content of financial reports but means that the transactions that lead to the final statements are much more secure.

What can be said is that management today is much more informed about the deficiencies of financial reports, but still experience some difficulty in saying whether a deficiency is material or not. There are some flaws in the Sarbanes-Oxley Act, and the judgement of the materiality of errors is a difficult judgement to make. Material errors in financial reports may therefore not be due to errors in the process of creating the reports, but to management being willing to change the figures.

The SOX law exists because of financial scandals and management willing to manipulate. Although SOX leads to detailed control in financial departments the changes may not happen there, instead happening when the managers start to panic five hours before they have to release the reports officially. It is at this time that management can take the wrong decisions and change the report and the financial department has no control over this, it is the management. One can actually have a very good internal control system but this does not take into account the CEO. If the CEO visits the financial department and says that turnover has to be increased by 50 million, there is a great deal of pressure to comply.

Regarding the role of auditors during the SOX project, as the company is not big, there are no internal audit department, no internal auditor, and the external auditors were not
involved in the implementation process of SOX. In fact, The company does not have to report SOX until 2008, meaning there is still a year left before the external auditors can start to report on the company’s internal control system, and to avoid independence questions the external auditors do not want to be involved in the SOX project.

However around ten people of the forty-four people in the financial department, have been trained to execute some internal audit functions on a regular basis to support the SOX implementation.

4.2.3.c/. SOX and the European and national perspective

Concerning the Swedish reaction, there are approximately 18 companies that have to comply with SOX in Sweden. Most of the companies complying with SOX have stock traded in the US, and two or three companies have to report to the SEC because of debt. In addition there are all American companies that have subsidiaries in Sweden but do not really have their own approach to Sarbanes-Oxley because they have directives coming from the mother company.

Most of the Swedish companies have had negative views of SOX, because it is a lot of effort, and administration. Perhaps this is due to the fact that they were forced to hire a lot of external consultants to implement SOX, which increased the cost of the implementation process. Figures like two or three million SEK for implementing SOX have been suggested. Maybe those companies have not focused on the main risks and they have not taken ownership of the implementation process, that is to say, interpret the law in a positive way for the company.

On a legal level the Sarbanes-Oxley act has impacted Swedish companies with the creation of the Swedish corporate governance code. The Swedish Corporate governance code is like SOX but at a more comfortable and less detailed level. The difference between the two is that Sarbanes-Oxley is a law and the Swedish corporate governance code is just a recommendation. When a company implements the Swedish code it is appreciated by the market.

4.2.3.d/. Global assessment

Concordia bus did not expect that its approach to SOX would be so appreciated and different from other companies. The company considers SOX to be a natural process that has been formalized by American law. Many journalists and other companies have been interested by the particular approach of this company.

Concordiabus is satisfied with SOX because of the new perspectives it offers, and because they find it good not to focus purely on profitability, but also on internal control. Sarbanes-Oxley forces companies to focus on all transactions before producing external financial reports. Most management is often focused on profitability and the income statement and they forget about the balance sheet and the cash flow statement. SOX pushed them to see that there could be some other interesting figures to look at.

Another good thing about SOX is that employees’ work is improved, especially within finance departments. There is a higher level of competence, and rather than just performing normal working transactions, the employees feel more responsible. There is a more important focus on finance people and their competence is valuable for the company.
The risk assessment process has also been a good thing for the company and now the company uses risk assessment for all kind of views not only financially, but also for the operational part of the business which is another positive effect.

The respondent would recommend that other companies follow the COSO framework, because SOX is not necessary. In the respondent’s opinion, COSO is a good model of internal control that keeps companies focused, and provides a good risk assessment process. Following COSO adds value to the company, focusing on the highest risk and finding deficiencies, which can overcome to help a company improve. However, COSO has to be used with a portion of good sense and not in too great detail. Companies should use COSO in the normal sense of the system, because then it is effective.

4.3/. Findings from the third company

4.3.1/. General background of the company

Stena Line was founded at the beginning of the twentieth century and became one of the largest shipping companies, thanks to different acquisitions of other shipping companies.\footnote{Information on: http://www.stenaline.com/stena_line/stena_line_koncernen/om_stena_line/en_gb/historik.html} Stena Line is a part of Stena AB, which is owned by the Olsson family. Stena Line is a transportation and travel company, and one of the first ferry operators. Stena Line is a leader on all its markets.\footnote{Information on: http://www.stenaline.com/stena_line/stena_line_koncernen/en_gb/om_stena_line.html} Stena Line is present in three areas it has defined as: Scandinavia, the North Sea and the Irish Sea, in order to provide a more efficient and better quality service to its customers.\footnote{Information on: http://www.stenaline.com/stena_line/stena_line_koncernen/om_stena_line/en_gb/affarsomraden.html}

In 2006, Stena Line’s profit was SEK 540 million, or an improvement of SEK 283 million compared to 2005. The revenue of Stena Line for 2006 was SEK 9.2 billion. And around 5,700 employees work for Stena Line, 3,000 of them onboard. The financial reports of Stena Line are not available because it is a privately owned company.

4.3.2/. The interviewee

At Stena AB, we had the opportunity to interview Mikael Stenvaller, who has been working in the company for three and a half years. He is the head of corporate governance, and responsible for SOX implementation within the Stena group. He reports to the audit committee of the company. Before working at Stena, he was an auditor at Ernst and Young and encountered SOX there.

Stena initiated the SOX project about two and a half years ago.

4.3.3/. Findings

4.3.3.a/. Consequences of the implementation of section 404 of SOX
• **Reasons for implementing SOX**

Since Stena has bonds in the US capital market, they have to comply with SOX requirements. They are going to keep some parts of SOX, even after having paid back the loans. They are taking loans in Europe, and paying back one of their American loans but they still have two loans left in the US.

• **Implementation process**

SOX started as a project, but then that was postponed given that they are non-accelerated filers at the SEC. Hence, they don’t have to file their management report on internal control until the 2007 financial year (i.e this year). And the external auditors will have to audit it for the first time in the 2008 financial year.

In order to implement SOX, they worked in accordance with COSO.

- First of all, they identified the risky subsidiaries that should be included in the SOX scope, by looking at the assets, earnings and equity and turnover in the subsidiaries.

- Next, they tried to identify the significant processes that have a bearing on the financial reporting, and they set up a number of control objectives that should be fulfilled within each process. In order to do the documentation for this part, they worked a lot in workshops.

- Next, they selected a number of key controls, set up a maximum of ten for each process, and did testing to ensure that the controls are working and well described.

- In addition, they did a lot of process matrices with flow charts in order to understand the processes.

The respondent presented us this scheme, noting that it is before the new directives set up by the SEC. Indeed, as there have been so many complaints in the US relating to the cost of implementing SOX, and because the SEC did not intend there to be so much detail, the SEC will produce some new directives. These directives state that the companies have to do a risk assessment, and try to find the risky areas and focus more on them than on all the details. So it will be more focused on the entity level controls, and less on the transaction level processes.

In order to implement SOX, Stena used a project team. Mikael Stenvaller is working for Stena AB and reports to the Board Committee. He has some help from the two major subsidiaries Stena Line and Stena Properties, where one person in each company is helping him with the documentation. They also have a number of workshops where people from the whole process get together, and go through all the controls, analyse them, and make some changes as necessary.

• **Changes due to the implementation of SOX within the company**

With the implementation of SOX, the respondent has noticed some interesting changes:

- Going through the financial processes has been a good test in order to both
increase internal control and make the processes more effective. For instance, they have installed some more IT tools where the controls were done manually before.

- The group is now more focus on internal control.

- They implemented an audit committee they did not have before.

- The costs have increased marginally but without the huge expenditure other companies might have engaged in, since most of the work has been done internally, without expensive exterior consultants. Since they did not use any consultants, the cost is mainly the cost of the employees working with SOX. During the implementation process, there were only three people working full-time with it.

- They had more time to do the work, as they had one more year compared to most Swedish companies. As a result they have been able to see, analyse and learn from them.

- Thanks to SOX, they save more documentation of the controls when they are performed, and they have to test these controls. Of course these additional duties had to be incorporated into normal working practice. This enabled the respondent’s company to make some changes in order to achieve a better segregation of duties.

- They started to use the COSO with SOX. Before, they did not have any internal control function. There were controls before, but they were not documented and were not reviewed.

4.3.3.b. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements

The company’s managers have regular meetings with their auditors during the implementation process, and present their documentation, and discuss planning. So far, the auditors have been satisfied, but are not required to report this year. They will have more work next year.

SOX has brought some changes in financial statements such as making them more focused on internal control, and introducing more documentation and more testing, better control and access to IT systems, and a better segregation of duty. For the content of the financial statements, they did not have any material misstatement to change.

4.3.3.c. SOX and the European and national perspective

There is the eighth directive in the European Union, and there is the Swedish Corporate Governance Code in Sweden. This legislation is moving in the same direction as SOX, but not as far as SOX. There were some financial scandals in Europe also, but it is currently experiencing a quieter period.

Many companies have complained about the cost of implementing SOX, and so the movement coming in Europe will perhaps not contain so many details. Now, the auditors are more confident in what has been done until now to implement SOX, and
Empirical Findings

the work they ask from the companies is less detailed. We are moving toward a focus on the areas of highest risk, a thorough risk analysis and less documentation within the processes.

As an auditor, the respondent was involved in some SOX implementation projects and he used to deal with much greater detail. At Stena, however, they try to keep it as simple as possible, because they need to update it every year and they want to have the control over it themselves.

Stena is a privately owned company in Sweden, and is not listed in Sweden. Therefore, they do not have to follow any Swedish code regarding corporate governance. However the respondent thinks that it would have been no problem to comply with it since the company is SOX compliant now.

4.3.3.d/. Global assessment

Regarding some unexpected consequences of SOX at the global level, the respondent thinks that it has been the cost of implementation. There have been so many articles and discussion about the cost to companies, which are now avoiding the American equity market. The Americans are perhaps afraid of what could happen, (such as losing their jobs on the financial markets), and that is why the SEC has to issue this new directive, making the process easier for companies. Now, the companies are increasingly looking to the European market. The last bonds Stena issued were in the European Union.

For the company itself, at the beginning, the respondent does not think that everybody understood the huge amount of money the implementation of SOX represented.

Mr Stenvaller thinks that the process has been quite good for in many respects, because they had to go through their financial processes. Some IT processes have been introduced instead of doing things manually. Now, they have more controls over the risks, which have been presented to the audit committee. He is in a workshop with other companies in Sweden, and it appears that Stena used less time and fewer consultants than other companies, and the cost has not been so significant for Stena.

He is satisfied with the internal control aspects of SOX since they did not go into too many details from the beginning, and focused more on the risk area. It has been good for them not to use external consultants who would have worked according to the Auditing Standards 2, and gone into too much detail. Therefore, they know their processes, and their controls, and it is easier to update the documentation every year. They also learnt a lot from each other during the workshop they were conducting.

He thinks that it is good to implement such a process in a company, if it is not too detailed, if it is done using a risk-based approach and if the process is examined with a view to improving them.

4.4/. Findings from the fourth company

4.4.1/. The interviewee

The respondent of our fourth interview prefers to stay anonymous, and requested that the name of the company does not appear in our report. He is called R4 in our report
(fourth respondent), and his company is called C4 (fourth company).

R4 is the project leader for Sarbanes-Oxley in his company, and is based at the headquarters of the group. He was previously an auditor at one of the big auditing firms before coming to C4 to work on Sarbanes-Oxley. He told us that most companies actually hired people from the audit sector when they started SOX.

4.4.2/. The findings

4.4.2.a/. Consequences of the implementation of section 404 of SOX

- **Reasons for implementing SOX**

At C4, SOX has to be implemented because the shares of the company are listed on the NASDAQ. R4 presented the main reasons for a company having to comply with SOX: having stocks or bonds listed on the American Stock Exchange, and having more than 300 shareholders that are US citizens.

- **Implementation process**

The SOX project was initiated at the beginning of 2004. In January and February 2004, C4 started to discuss the kind of approach they should have, which companies of the group should be SOX compliant, and the requirements.

To describe the implementation process, R4 sent us a scheme to show the different phases of the project (figure 4).

R4 told us that it had been hard work to implement SOX. Initially, when European companies started to work with SOX, all the auditors and consultants were very cautious about the requirements, and asked that everything be done in great detail. However doing everything is such great detail takes a long time, there is a need for a lot of resources, and then the costs become very high.
The first step was to set up the approach and the scope. Within a large group like C4, not all the companies within the group are required to do SOX. As a result they have selected the most important locations, the most important units. Indeed, they have around 400 companies, and 200 are involved to some extent in the scope of SOX.

When they made the selection of the companies, and defined all the instructions, they gave the instructions to the selected subsidiaries. The second phase was the documentation of the processes and controls, which was a local responsibility. As such all the companies that were in the scope had to start to document their processes and controls in the documentation formats.

Next, all the companies had to assess their controls, and see if they were properly define. They then had to test all the controls to make sure that they all worked as intended.

The final phase for a company such as C4 is that all the companies need to sign off to headquarters that they have done the work as they were supposed to do it.

Fundamentally, therefore, there are three most important phases: Documentation, Assessment, and Testing.

- Changes due to the implementation of SOX within the company

C4 is a relatively old company, which means that routines had been established for a

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104 From our interview with R4
long time. C4 had good internal control even before SOX, and there has always been a high focus on corporate governance. However, through the implementation of legislation such as SOX, the awareness of internal control and corporate governance increases within the organization.

The company has maintained the very good internal control structure they had before. Now, however, they have evidence that it is working properly.

At the same time, R4 believes that high level management, and middle management are much more aware of the importance of internal control.

In terms of organizational changes, there have been some changes due to SOX. Prior to SOX, C4 had an internal audit department at its headquarters. Following SOX, however, it has been decided to split it up into two organizations: an internal audit organization and an internal control organization. R4 is based at headquarters, in the internal control department. SOX has also affected the organization given that some people needed to be hired.

The cost of implementation was much higher than anticipated at the beginning of the project. In 2004, when the project started, no one really knew what to do, how long it was going to take, or the costs associated.

In most cases, the management has kept the work procedures and processes they had before. However, they had to implement a procedure for evaluating their internal control.

COSO was used with the implementation of SOX. They were partially using it before SOX, but now it is used as their framework. From an IT perspective, they are using COBIT, since in terms of control perspectives, both COSO and COBIT are more or less the same.

The company had good internal control over financial reporting before Sarbanes-Oxley. SOX brought more awareness of the importance of internal control within the company but there were no significant effects on internal control over financial reporting. The financial reporting of the company was of good quality before SOX.

4.4.2.b/. Internal Control over Financial Reporting (ICFR) and the reduction of material errors in financial statements

The company was in quite close contact with their auditors, throughout the implementation process. Certain sections of the Sarbanes-Oxley legislation explain the independence of the auditors, although those sections are not applicable for all companies but only to external auditors. The auditors need to be independent in what they do, and they cannot perform any consulting services for the companies they audit.

The company used consultants during the implementation, and especially at the beginning of the implementation process, the consultants were speaking partners. And the external auditors have worked very closely together on the audit, centrally, especially during the last three years and even more the first year after the certification. Cooperation with the external auditors and consultants has been very good. Sarbanes-Oxley is also new to them, so at the beginning they did not know much either.
The external auditors were initially cautious of having discussions with the company. Due to the independence issue, they felt that they needed to be very independent. Now, however, that the SEC has explained more about the legislation, and the independence issue is not that crucial any more. Currently the situation is as it used to be before Sarbanes-Oxley, that is to say the company has a very close cooperation with its external auditors a usually this way for big companies.

There has been no change in the way the company presents its financial statements due to SOX.

C4 does its annual financial statements based on IFRS principles, and then as the company is listed on the NASDAQ Stock Exchange in the US, it also has to file another annual report where it includes information according to US GAAP. This second annual report that the company files with SEC in the US, is called form 20 F. In form 20 F the company has added a section where the CEO and CFO attest that the assessment of Internal Control over Financial Reporting has been realized and that the company has no material weaknesses.

Fundamentally that is the only change in the format of the financial statement of the company. The quarterly report or Swedish annual reports have not changed. There is simply more detail about corporate governance in some sections.

4.4.2.c/ SOX and the European and national perspective

The comparison between European companies’ reactions and those of US companies can be interesting. The SOX law was signed in 2002 and US companies had to comply in 2003. They started the implementation process and went into a detailed assessment of internal control. There implementation process was driven by consultants and auditors so they simply jumped into a workload that was very heavy. The following year when European companies realized that they would also have to implement SOX, the implementation process had a little more sense and the companies were not forced to turn to consultants or auditors so much. As such the level of strain was not the same as, there were not so much detail required as in the US. US companies are now reducing the level of detail of their SOX processes and they are becoming more risk based when they do Sarbanes-Oxley.

The reaction in Europe and in Sweden was that the legislation forced companies to go into too much detail. The respondent’s company used consultants who developed a SOX process at a very detailed level because consultants earn more money when they advise the companies to do a detailed implementation. Therefore the implementation of SOX was driven by consultants at the beginning and they were going into too much detail.

Now the reactions to SOX are more reasonable, and the company of the respondent has found its way of complying with SOX. Even so, companies still feel like the cost for keeping compliant is high.

At the EU level and also at the national government level, steps are being taken towards Sarbanes-Oxley. There is the 8\textsuperscript{th} EU directive, meaning Europe will follow SOX to some extent but not with the same detailed requirements of the companies.
In another part of the world there are countries that have copied Sarbanes-Oxley legislation, for instance in Japan with J-SOX. Therefore not only Europe but also the rest of the world is following to some extent the US initiative of Sarbanes-Oxley. Filing for Sarbanes-Oxley helps to cover any other requirements that come from any European or Swedish legislation. By complying with SOX you are automatically covered for any other legislation.

4.4.2.d/ Global assessment

The first unexpected consequences to be considered are the cost, and the timing. It took more time than expected, based on the volume of work that needed to be done and on the number of units that were involved. Some processes became more inefficient due to SOX because of the new formal requirements, while others became more efficient. The company had to document all the processes, and this way it discovered that some of the processes were done in too great detail and others needed to be more detailed to be improved.

The company is quite satisfied to have been able to implement SOX. There were many facilities involved, and many people around the world and from the different organization that were involved. It was a huge project, and has been one of the company’s largest projects on a global level.

On the other hand what was not so satisfying was the cost and also the fact that the company was mislead by consultants at the beginning of the process, meaning that it went into a level of detail that should have been avoided.

There are also some benefits such as corporate governance and internal controls since there have been highlighted in the entire organization. Now the company has a high focus on internal control. However the cost for being SOX compliant for the moment is higher than the benefits.

This year and the next year the company will probably do something to make the benefits more valuable than the costs.

Sarbanes-Oxley is legislation, and if a company does not have to comply with the legislation it should not try to implement SOX because there are better ways of having good internal control.

Now there are companies that are talking more about internal control and corporate governance. Many companies have started their internal control functions and the internal audit function but they do not need to do it in the SOX way and not in such a detailed manner.
### 4.5. Summary of empirical findings

We have built this table to summarize the different findings we made from the interviews with companies, in order to see the results in a more effective and clearer way. As we present the answers in parallel, it is easier for us to conduct the analysis.

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<tr>
<th>Section</th>
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<th>Concordiabus</th>
<th>SKF</th>
<th>STENA</th>
<th>Fourth company (C4)</th>
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<tbody>
<tr>
<td><strong>1/. Introduction</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Respondent</td>
<td>Anika Kolmert</td>
<td>Anders Widegren</td>
<td>Mikael Stenvaller</td>
<td>R4</td>
<td></td>
</tr>
<tr>
<td>Role in the company</td>
<td>SOX project manager</td>
<td>Internal audit department. Responsible of the entity level controls</td>
<td>Head of the corporate governance, former auditor at Ernst&amp;Young</td>
<td>Project leader for SOX, former auditor</td>
<td></td>
</tr>
<tr>
<td>Beginning of the SOX implementation</td>
<td>2005</td>
<td>2003, March</td>
<td>2 years 1/2</td>
<td>2004, January</td>
<td></td>
</tr>
<tr>
<td><strong>2/. SOX implementation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reasons for implementing SOX</td>
<td>Debt holder with a lot of American interest</td>
<td>Listed on NASDAQ, delisted in 2005 but still on the OTC market in the US + loans/bonds in the US</td>
<td>Bonds in the US</td>
<td>Shares listed on NASDAQ</td>
<td></td>
</tr>
</tbody>
</table>
### Empirical Findings

| Changes with the implementation | - More focus on internal control  
|                                 | - More focus on the BS and CF  
|                                 | - Secured transaction processes  
|                                 | - Improvement of management competences  
|                                 | - Creation of controls  
|                                 | - Management more secure about financial statements  
|                                 | - External costs: SEK 700 000  
|                                 | - Internal costs: SEK 2.2 million  
|                                 | - Implementation of COSO  
|                                 | - Improvement in internal control in general  
|                                 | - Controls more described, more formulized  
|                                 | - Internal control became a more solid and robust system  
|                                 | - Negative part: a lot of costs and time issues  
|                                 | - Section 404: around SEK 100 million  
|                                 | - More awareness (controls, policies…)  
|                                 | - Segregation of duties  
|                                 |   => A more structured approach to internal control  
|                                 | - Awareness of the utilization of the COSO model  
|                                 | - Utilization of COBIT  
|                                 | - By going through the financial processes-  
|                                 |   >good testing to increase internal control and more effective controls.  
|                                 | - Implementation of IT tools  
|                                 | - More focused on internal control  
|                                 | - Audit committee  
|                                 | - Costs increase  
|                                 | - COSO implementation  
|                                 | - Better segregation of duties  
|                                 | - Documentation and review of controls  
|                                 | - Awareness of corporate governance and internal control  
|                                 | - Very good maintained internal control structure  
|                                 | - Evidence  
|                                 | - Awareness of the management of the importance of internal control  
|                                 | - Internal audit department split up  
|                                 | - People hired  
|                                 | - Costs higher than expected  
|                                 | - Timing longer  
|                                 | - Creation of evaluating procedures  
|                                 | - Full use of COSO (partial use before)  
|                                 | - COBIT  

### 3/ SOX and the reduction of material errors in the financial statements

| Role of auditors in the implementation | None for the external auditors. Consultants for the methodology support.  
|---------------------------------------|-----------------------------------------------------------------  
|                                       | External auditors: independent, and no role in the implementation. Consultants at E&Y  
|                                       | No external consultants  
|                                       | Regular meetings with external auditors  
|                                       | External consultants  
|                                       | Close relationship with the auditor  

58
<table>
<thead>
<tr>
<th>Change in their role</th>
<th>No</th>
<th>External auditors kept outside the process, auditors not implementers.</th>
<th>Will have more work when SOX audit</th>
<th>Beginning: very cautious because of the independence issue. Then, closer relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in the financial statements</td>
<td>No changes noticed, beginning of the process. Improvement of procedures to register the transactions in the financial statements.</td>
<td>No changes noticed. About disclosure: US GAAP and IFRS nothing in SOX. Changes in the controls for producing the financial statements.</td>
<td>No material misstatements. More focused on internal control, better documentation</td>
<td>None The CEO and CFO signing the 20F -&gt; change in the presentation of the financial statements</td>
</tr>
<tr>
<td>4/. ICFR in the European perspective</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reaction to SOX</td>
<td>Sweden: played a role for the corporate governance code creation. Bad reaction because of the costs and time-consuming consequences.</td>
<td>At the beginning not really enthusiastic: too time consuming, too costly. Has become an administrative nightmare. Pretty much an over-reaction. It is just too much (details, controls…). But has changed during the process, and now people think it is good.</td>
<td>Complaints about the implementation cost Moving toward something at both levels, but not as far as SOX At the beginning, useless work for a lot of companies in the risk assessment process because too much detailed</td>
<td>Misleading of companies by consultants Too many details Important costs Then, costs become more reasonable Companies find their own way to implement SOX</td>
</tr>
</tbody>
</table>
### Impact of European and Swedish legislation

<table>
<thead>
<tr>
<th>Impact of European and Swedish legislation</th>
<th>Swedish corporate governance code: only recommendations. Doing SOX, you answer to the Swedish corporate governance code requirements.</th>
<th>Not a very big impact. Swedish corporate governance code is much less strict. SOX has had the biggest impact.</th>
<th>Privately owned company, so not listed and do not have to follow any Swedish code. But would not have been a problem as SOX compliant</th>
</tr>
</thead>
</table>

**6th European directive**  
Creation of J-SOX in Japan  
When SOX compliant, answer to all other requirements

### 5/. Global assessment

<table>
<thead>
<tr>
<th>Unexpected consequences of SOX</th>
<th>Personal approach to SOX: some companies came to get some advice from them. Improvement of employees’ competences.</th>
<th>Testing: thought some fundamental and basic processes would be there, but no. Surprised that companies became rather pro-SOX late in the process. The amount of work, and timing.</th>
<th>- Because of the costs, companies are avoiding the American equity market - lighter directive from the SEC - Amount of work</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>- Costs</strong></td>
<td>- Costs</td>
<td>- Highlight of internal control and corporate governance</td>
<td></td>
</tr>
<tr>
<td><strong>- Timing</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>-</strong></td>
<td></td>
<td><strong>- Costs more important than benefits</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Satisfaction with the internal control aspects of SOX

<table>
<thead>
<tr>
<th>Satisfaction with the internal control aspects of SOX</th>
<th>Very satisfied, especially with COSO. Something natural, formalized by SOX.</th>
<th>Happy with the idea of SOX, and especially COSO. SOX approach is not really so good. Project has been good.</th>
<th>Satisfied since focused on the risk area, pragmatic approach. And now easier for them to update.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Satisfied to have efficiently implemented the project at such a global level</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Recommendations to others

<table>
<thead>
<tr>
<th>Recommendations to others</th>
<th>Implementing COSO.</th>
<th>Implementing COSO, definitely. Thinks something is going to happen at European level.</th>
<th>Good if not in too much detail. Risk-based approach and go through the processes.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Not for SOX</strong></td>
<td></td>
<td><strong>Better ways to implement good methods of internal control</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Table 4: Summary of empirical findings**
CHAPTER 5: ANALYSIS OF THE DATA

In this chapter, an analysis of the data presented previously is done, matched with the elements of the theoretical framework. A first step to find efficient answers to our research question.

We are aware of the fact that we cannot generalize our findings to all Swedish and European companies given the type of study we have chosen to do. However, we have made some interesting findings within the four companies we interviewed, that have more general relevance given our observation during our research into the topic. These aspects can be of interest for companies working on their internal control system. It can be interesting for them to take into consideration the issues we identified during our research.

5.1/. Introduction

5.1.1/. Reasons for implementing SOX

Of the four companies we interviewed, three of them are debt holders on the American market. Indeed, Concordia Bus has bonds issued in Luxembourg but owned as a majority by American citizens. That is why the SEC requires that they report under the Sarbanes-Oxley Act. STENA, meanwhile, has loans in the US stock market, and so has to comply with the SOX requirements. The third company, SKF, has to implement SOX because they are debt holders, and also because they are still listed on the OTC (Over The Counter) market after being delisted from NASDAQ in 2005. C4 is listed on the NASDAQ, and therefore has to comply with SOX.

One of the main findings in the study about the implementation of SOX is that it does not only concern equity markets. The main idea we had, that only companies listed on Stock Exchanges in the US to find equity capital had to implement SOX, has changed following our study. It appears that the debt dimension is an important perspective when considering SOX compliant companies. American interest in the companies is a major reason to have to implement SOX.

Indeed, when companies have more than 300 American citizens as shareholders, they have to file with the SEC. And, when the companies have bonds or stocks on the American capital markets, they also have to file with the SEC.

Due to this debt structure of the companies, when they finish repaying their debts on the American markets, they have the choice of whether to keep on using SOX without reporting to the SEC anymore. It depends on the companies’ willingness to maintain strong internal control as in SOX.

Moreover, this aspect raises another question for the American market and the new risk they could face. Indeed, more and more companies could search for funds on the European market in order to avoid having to comply with the over-detailed and heavy legislation as in the US.

5.1.2/. Implementation process

The implementation process for SOX compliance, within the four interviewed companies, differed slightly in some aspects. However, the general and main ideas and principles of
this process were the same. Many of the elements stated in the planning considerations of our theoretical framework are identified in the process used by the companies to comply with section 404. Even if it is not as described as in the theories, the main steps are there.

Indeed, the four companies all used a project team in order to conduct the project efficiently. They all used the COSO model to support the implementation of SOX section 404. However their interpretations of the COSO framework were different. That is to say they used differing amount of detail when implementing the different controls and their testing. STENA and Concordiabus stayed on a less detailed process, while SKF went into more detail.

The four companies conducted a risk assessment of the processes at the beginning of the project. Then, they all set up controls and control objectives based on these identified risks. When a company focused on the more important risks, it used a less detailed COSO framework, and vice versa.

To get help for the implementation process of SOX, the companies could use external consultants. Three of our companies used external consultants, but for different reasons: Concordiabus for instance used the consultants just for methodology support and did not rely on them for the implementation itself; whereas SKF and C4 used external consultants as a real guidance for the implementation, at a more extensive level. STENA did not use external consultants, in order to be more responsible for the processes, to become more aware of them and to allow an easier follow-up of the processes in the future (review, update; additional costs if consultants have to come back to solve some problems...).

The methods used for implementing SOX within the companies are coherent with the general framework we have studied in our theoretical chapter. The general steps are identified, and the process is the same, even if the way the respondents explain it was not so detailed and precise.

5.2/. Changes with the implementation of SOX

5.2.1/. Organization perspective

When we look at the organization within the companies after the implementation of SOX, several changes can be noticed.

Three of our interviewees had not created a specialized department to manage the SOX project, although there have been some changes among the employees. In some of our companies, existing employees had additional training to exercise the tasks of internal auditors. Some employees of the company have seen their number of tasks increase because of the new requirements imposed by SOX. This has been the case in Concordiabus, for example, where some people within the finance department received additional training in order to be able to deal with SOX on a continuous basis. C4 has created an internal control department, splitting up the former internal audit department into a new internal audit organization and a new internal control organization.

The implementation of SOX has forced the management to diversify their knowledge of the procedures used in the companies for the construction of financial reports. It has had to be more and more interested in the way financial statements are constructed given that it is responsible for their fairness. This enabled an improvement in the management’s competence, as happened in Concordiabus. Indeed, the management is not only focused on
Analysis of the data

profits anymore, but also on the Balance Sheet, the Cash Flow Statement, internal control as a whole, and the risks the firm can encounter.

In another company, more employees have been hired because of SOX and the new tasks that have to be done related to SOX. For instance in SKF, the internal audit department has grown from one to six people during the implementation period.

In three of our companies, the respondents mentioned that SOX has brought a better segregation of duties given that every task has to be done and then reviewed. As such, the tasks have to be well and precisely defined by polices and instructions, and assigned to specific people.

One of the requirements of SOX and COSO is the presence within the company of an audit committee and a steering committee. Each of the four companies we have interviewed had to create an audit committee. As we stated in our theoretical framework, the creation of this audit committee is a change brought about by SOX, in order to improve the independence of auditors. Previously, auditors had to report to the management, which could create interest conflicts as it is difficult to contradict the management. With the audit committee, the independence of the external auditors is preserved, since the members of the audit committee has to have a background in accounting and finance, and be independent from management. Some of our interviewees had to report directly to the audit committee and were in direct contact with the members of this committee. This is the case for the STENA interviewee who reports directly to them.

It appears that the requirements of SOX have generated some positive evolutions in the companies’ organizations. It has made the companies think through their entire organization and evaluate the changes and improvements to make in order to have a better, more efficient and more reliable internal control system.

5.2.2/. Timing considerations

Two of our interviewees have to report to SEC in 2008 about their Internal Control over Financial Reporting. But they are already concerned with the implications SOX will have in terms of updating processes in the future.

For Concordiabus for instance, the SOX project itself took nine months. But our interviewee specified that the implementation process would take more time because employees and different departments in the company and the subsidiaries have to understand and integrate the process. “Producing a policy or some instructions was not sufficient, we needed to do the changes at all levels and people had to accept and understand the new procedures”. Therefore, SOX is a long-term issue, not only during the implementation phase.

5.2.3/. Cost considerations

The costs considerations were greatly dependent on the way the companies interpreted Sarbanes-Oxley. There is no standard cost for the setting up and utilization of SOX within the companies. Each one has its special features, and special processes, that generate variable costs. The external costs were higher when SOX, or COSO, were applied in detail and many consultants were involved in the process.

105 From the interview with A. Kolmert at Concordiabus.
It was difficult for our interviewees to give us specific figures. Indeed, it is hard for the companies to identify the different variables that will directly impact from the implementation of SOX. SOX is a long-term process and all the costs are not known for the future. Moreover, within the company and this specific project, it is difficult to determine whether a particular task is as a result of SOX and not a part of the usual activities of the company. However, two of our companies have an idea of the costs for their SOX project. Concordiabus evaluates the external costs at SEK 700,000, while the internal costs represent SEK 2.2 million. SKF evaluates its costs to, at least, SEK 100 million. STENA did not give us any specific figure, but Mikael Stenvaller told us that he estimates that SOX takes a lot of internal resources, and represents a large internal cost. R4 was not able to give us any figure for the cost of the project, but stated that it had been much higher than expected.

The cost issue has been one of the major issues with the implementation of SOX. The companies were not really aware of what the project required in terms of internal and external resources. This has had a significant impact on the companies, and it is important to take this into consideration. In our research for this study, we have found many articles reinforcing the fact that the estimation of the costs made by the SEC was wrong, and that it misled companies about the costs of their SOX projects.

5.2.4/. Processes

The implementation of SOX has improved the communication processes within the companies we interviewed. COSO requires that the employees are aware of the values and the policies within the company, which means communication through the different levels of the companies. COSO also required better communication among all the employees and all the hierarchical levels of the company for better information. At SKF, for instance, the finance people and SOX coordinators went to the different subsidiaries to explain what SOX was, what they were doing, why and how. A web page was created to keep everyone better informed.

IT (Information Technologies) is an important part of internal control as well. SOX recommends COBIT be implemented in the companies, and it is for this reason that it is used by SKF and partially by C4 among our respondents. Thanks to SOX, a lot of processes and controls have been computerized instead of being done manually. This enables an easier review and analysis of the tasks being done and the correspondent controls. STENA told us that IT tools have been created within all the processes thanks to SOX. SKF, meanwhile, explained that IT tools have been useful, even necessary, administering the processes and the 3 to 4,000 controls they have in their 40 units in the SOX scope.

All our respondents stated that they had to create specific controls, or improve the existing ones, in order to comply with the SOX requirements of internal control. From a more general perspective, all our companies found that there has been a better focus on internal control as a whole. Indeed, the introduction of SOX has enabled them to create, or improve, their internal control processes. Our respondent at SKF has described their internal control as a “more solid and more robust system”\(^\text{106}\) thanks to the elements required by compliance with SOX. Concordiabus recognized that they are now more focused on internal control. Finally, STENA stated that going through the financial

\(^{106}\) From our interview with Anders Widegren at SKF
processes with SOX helped to improve the controls, and to focus more on internal control, and to increase it. C4 was in a quite particular situation, given that their internal control was good even before SOX. However, SOX has brought a review and improvement of the existing controls.

One weakness of the process has been brought into mind concerning the independence of the finance department related to the management. Indeed, even if the internal control system is perfect, if the management decides to manipulate the figures when the reports are presented, it is difficult for the finance people to go against management.

5.3/. Internal Control over Financial Reporting and the reduction of material errors in the financial reports

In order to respect the independence required by SOX, the external auditors do not have any role in the implementation of it. All our respondents state that their external auditors did not take part in the process as they are not allowed to. They can have discussions with their external auditors, but these ones cannot be dependent on the implementation part of SOX. Our four companies stated that this independence has been respected with their external auditors.

However, the auditors have been used as external consultants by some companies for guidance in the implementation process. In their companies, SKF used external consultants. However there is also another opinion, according to which, it could be better not to use external consultants. Indeed, an interesting critic has been brought into our mind by one of our respondents. External consultants, most of the time, use Accounting Standard number 2 from the PCAOB to help companies implementing SOX. This way, they ask companies to do as much work as the external auditors will have to do when certifying internal control process in the company. Hence, they interpret COSO in a very detailed way, and ask the companies to go very deeply into their implementation, review, and testing of the controls. There are then risks of a lack of efficiency in the internal control system, a waste of time, a waste of money, and difficulties in reviewing and updating processes that the employees are not really aware of (if they are less involved in the implementation).

None of the four companies has been confronted with important material errors in their financial statements. However, thanks to a better internal control system, there are fewer minor observations from the external auditors performing the financial audit. At SKF, for instance, our respondent told us that in some countries, there have been fewer minor observations from the external auditors than previously. But the difficulty remains in identifying if these fewer observations are due to SOX, or due to general improvements within the company. Generally speaking, however, there has not been a huge impact of SOX on the content of the financial statements.

However, they all recognized an improvement in the methods of constructing financial statements.

- Indeed, for Anders Widegren at SKF “SOX has brought changes in the controls for producing the financial statements, but it has not really affected the content of the financial statements so much” that is to say that “SOX controls that the financial
For Annika Kolmert, at Concordiabus, “the financial statements have a fixed view; the only thing you can secure with SOX is all transactions that lead to this fixed view.”

Hence, SOX does not affect the content of the financial statements directly, but it affects the procedures for constructing the financial statements of the company.

This question has been sometimes badly interpreted by our respondents. Indeed, they did not want us to believe that they have major material deficiencies in their financial statements, and it was not our goal to suggest that they had.

Even so, we made some interesting findings through this question, given that we can see that a better internal control system enables better construction of financial statements. Even if no major changes in the content of the financial statements have been noticed, the method to getting the figure has been improved. This is a positive aspect of SOX, aimed at restoring confidence in the fairness of the financial statements of the companies.

5.4. SOX section 404 and the European perspective

The first reactions to SOX, both in the US and in Europe, were far from enthusiastic. The time-consuming nature and cost of the process have been the main issues. In Sweden, the companies witnessed a bad reaction concerning the SOX legislation. It was considered as an over-reaction by some companies, because it was too involved. There were too many details, too many controls etc.

During the course of the process, however opinion regarding SOX evolved, and the companies became more positive about this legislation and internal control. Even if SOX is still perceived as going too far in controls and in testing, the principle behind it is well accepted by the companies and considered as useful. A better internal control system enables the company to be run more effectively.

The Swedish legislation regarding internal control is mainly associated with the Swedish Corporate Code of Governance for the companies listed on the Stockholm Stock Exchange. However, this does not have a big impact on the Swedish companies we interviewed. Indeed, they regard this code as something less stringent than SOX, and as recommendations made to the companies. At the European level, internal control is associated particularly with directive eight, but similarly has little impact on them. SOX is the legislation which impacted the most on companies. By complying with SOX, companies comply directly with other legislation, given that SOX is far more advanced and detailed.

Our respondents mainly think that something more complete is going to happen, both at European and Swedish level. However they hope it will be something less bureaucratic, and less restrictive than SOX. R4 highlighted the fact that some other parts of the world are

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107 From our interview with Anders Widegren at SKF
108 From our interview with Annika Kolmert at Concordiabus
moving towards a system similar to SOX, such as the J-SOX in Japan.

Initial reactions to SOX were negative, both in the US and in Europe. However, an evolution of opinion is noticeable over time. The companies became more favourable to SOX and in particular to good internal control. This shows that, after all, there was a need for a change in the internal control area. Even if companies think that SOX was not maybe the best way to do it, the idea and principle behind it were good and necessary.

5.5. Global assessment

The four companies have identified unexpected consequences as a result of the implementation of SOX in their organisations, in terms of organization; time spent on set up, costs, approach, improvement of employees competences and testing. Concerning the testing aspects, at SKF they expected to find fundamental and basic processes and controls when doing the tests that they found to be missing. As such, it has been positive that SOX underlined this lack, and they have been able to improve the system.

However one interesting idea came up from one of our respondents as an unexpected consequence. Indeed, because of the huge cost and time spent on implementation, some companies are leaving the American stock markets and are moving towards the European market which is less restrictive. The SEC reaction is to lighten the procedures linked to SOX. It is issuing a new directive, more based on a risk-based approach of the internal control, and more focused on the main risks so that the law will be less demanding of companies.

Globally, our respondents are satisfied with SOX, and especially with the COSO framework. All the respondents recommend that other companies use COSO because they find it is an excellent tool for implementing an efficient internal control system. Two of our respondents underlined the fact that COSO has to be used according to its main principles, and it is not so important to focus on the details, but more on the major risks and linked controls.

Generally speaking, the companies consider that good internal control is necessary, and recommend that other companies do something at this level.

After the risk we have identified for the American market regarding the departure of companies from the US debt market, the risk is also at the equity market level. More and more companies are leaving this market because of the huge costs and constraints imposed by legislation such as SOX. The SEC recognized this risk, and has acted to reduce it. Indeed, before the end of 2007 the SEC will publish new guidance for the implementation of 404. “The new guidance will enhance compliance under Section 404 of the Sarbanes-Oxley Act of 2002 by focusing company management on the internal controls that best protect against the risk of a material financial misstatement.” This new guidance should also help to reduce the implementation costs.

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109 From SEC Approves New Guidance for Compliance with Section 404 of Sarbanes-Oxley, on www.sec.gov
CHAPTER 6: CONCLUSIONS

This chapter is going to answer the research question that has been stated at the beginning of this thesis: How does the section 404 of the Sarbanes-Oxley Act impact the European companies in terms of Internal Control over Financial Reporting? Therefore, the focus will be on the ideas that have been found in the analysis.

Thanks to our empirical findings, we can say that there are different advantages presented by the companies when complying with the Sarbanes-Oxley legislation.

The implementation of SOX has led the companies to improve their organization. With the new tasks and new competences required for compliance with SOX, some arrangements have been made, in terms of number of people hired, number of people trained. Generally speaking, there has been an increase in the employees’ and management’s knowledge and competences.

An audit committee has been created, an entity securing the independence of the external auditors from management, to restore the confidence of the investors in the fairness of the financial statements.

Some of the employees have seen their tasks redesigned to improve the processes in the company. There was a need for redefining the tasks attributable to each employee, identifying those responsible for the processes and for the controls. This led to a better segregation of duties within the companies.

An improvement of the communication and information channels has been observed within the companies. There was a need to inform the employees about SOX before and during the implementation to ensure the success of the implementation. Moreover, after the testing, some policies and instructions were communicated to all levels of the organization.

In order to sustain these communication and information channels, the companies have strengthened their IT tools. The work previously done manually has been computerized to facilitate the testing, and the quality of the procedure.

By testing all the risky processes, the risks of errors have been reduced. Hence, the method of constructing financial statements has improved. SOX does not directly impact on the content of the financial statements, however there can be a general improvement thanks to the work done upstream.

Finally, an important improvement has been noticed related to the internal control system as a whole. The companies are using the COSO framework in order to comply with SOX requirements of section 404. They are satisfied with the propositions made in COSO. They found that the COSO framework helped them to secure their processes, and to identify deficiencies in need of correction in their systems. A good internal control system is important for the company, since it enables management to have better control of the risky elements of the company.
By way of closing remarks, we would say that Sarbanes-Oxley has had a positive impact on the companies we interviewed, even if there are some minor questionable points in the legislation. Even if SOX is not recommended by our respondents for the companies who do not have to comply with it, it appears that COSO and internal control is something to think about for the future at national or even European levels.
CHAPTER 7: FURTHER RESEARCH

This chapter aims to propose some ideas estimated interesting by the authors for eventual further research in this area.

At the beginning of our research, we were thinking about studying the implications of SOX at the European level, with a particular focus on the French case. It has not been possible for us to continue this study. However, we had an interesting meeting with an auditor at an international auditing firm.

We think that the auditors’ point of view is an interesting one on such an issue. They can be either consultants for the implementation and used as guidance, or they can be external auditors for the SOX audit. Hence, they can see many cases of different companies with different sizes, different organizations, different structure etc. As such, they have an interesting overview of the SOX project.

Some of the information we got from French auditor corresponds with the information we collected from the interviews in Sweden for our empirical data, such as:

- Companies were not satisfied with SOX at the beginning because of the costs, the details and time issues.
- Companies are moving towards a less detailed implementation of SOX.
- More and more companies are delisted from the US Stock Market.
- The development of fraud audits is noticed.
- Companies are now satisfied with the internal control aspects of SOX, and want to keep them once they are in place.

We think it could be interesting to analyse the auditors’ point of view in the different European countries related to SOX and its implementation. Moreover, the results of SOX will become more and more visible as time goes on and it is something worthy of future study.
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Gary Cunningham, ‘Management Control and Accounting systems under a competitive strategy’, Accounting auditing and accountability journal, volume 5, No.22, 1992

Auditing firms documentation

Sarbanes-Oxley Act section 404, Practical guidance for management, Price Waterhouse Coopers, July 2004

Documents from the Internet

AU sec 316 on http://www.sec.gov/rules/pcaob/34-49544.htm

Concordiabus, www.concordiabus.com

COSO Description, Proviti KnowledgLeader, http://knowledgleader.com


Public Company Accounting Oversight Board, www.pcaobus.org

Sarbanes-Oxley section 404: a guide for management by internal control practitioners, Professional guidance, the Institute of Internal Auditors, at www.theiia.org


List of Swedish companies registered with the SEC, http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&State=V7&owner=include&count=40


StenaLine,
http://www.stenaline.com/stena_line/stena_line_koncernen/en_gb/om_stena_line.html

StenaLine,
http://www.stenaline.com/stena_line/stena_line_koncernen/om_stena_line/en_gb/affarsomraden.html
APPENDIX 1: THE CASE STUDY PROTOCOL

Overview of the case study project

Project objectives

The main objective of our case studies project is to obtain quality information regarding our topic of interest. Indeed, we want to have data that we will be able to use when writing the empirical part of our thesis. We need data that enable us to draw interesting conclusions, and to answer our research question, linked to our theoretical framework.

In order to achieve this qualitative data, we would like to settle a good relationship with the interviewee, a two-way relationship. The interviewee has to have an interest in our study if we want him to answer us.

Basically, we want to make a case study analysis in order to answer properly the research question we have raised in the frame of our Masters thesis.

Case study issues

The issues we will encounter when doing our case study are:

- Find the different companies
- In those companies, find the people able to answer our specific questions
- Build an interview guide that will help us in getting interesting data, and construct the way we want to get the information (interview, documentation...)
- Analyse those data, and draw some conclusions from them

Relevant readings about the topics being investigated

- Readings concerning all the theoretical background we would need to have some knowledge about the topic, and so be able to build the case, and to meet with the companies
- Readings regarding the case studies procedures, method and methodology, conclusions...

Field procedures

Credentials and access to the case study sites

- Identification of the companies implementing SOX in Sweden and in France. These companies will be the sites for our multiple case studies. We do not have any support, neither from the university of Umeå, nor Dijon Business School, to contact the companies. We can only use our personal relations, and the Internet

General sources of information
Appendix

- Websites of the companies
- Interviews
- General literature for secondary data

**Procedural reminders**

- Identification of the companies, SOX compliant
- First contact by mail, explaining who we are, what we are doing, why are we interested in our answers...
- If answer, then settle a date for an interview. If no answer, contact by phone with each company.
- Creation of the interview guide all along
- Pilot case study (we did not have the opportunity to do one for time purpose)
- Interviews
- Retranscription of the interviews
- Analysis of the data
- Cumulation of the data from the different sources
- Conclusions

**Case study questions**

*Questions that the investigator must keep in mind when collecting data*

- What are the consequences of the implementation of SOX in the companies, and not the way they have done it!
- Validity, reliability
- Answering the research question

*Potential sources of information*

All the sources described before related to the different types of questions

**Guide for the case study report**

*Outline*

- Presentation of the case study site
• Presentation of the results we get

• Analysis of the results

• Cross analysis between case studies

**Format for the narrative**

The narrative will be part of the thesis, each one a specific part of the findings chapter. The retranscriptions will not be added in appendixes at the end of the writing but still available for consultation by the reader on request.
APPENDIX 2: INTERVIEW GUIDE

Research question:
How does Sarbanes-Oxley Section 404 impact Swedish companies in terms of internal control over financial reporting?

Introduction

(1) How would you describe your role at the company you work for?
(2) When was the implementation process of the Sarbanes-Oxley act initiated?

Consequences of the implementation of the section 404 of Sarbanes-Oxley

(3) Why did you have to implement SOX?
(4) How would you describe the implementation process of SOX in your company?
(5) What has the implementation of SOX changed in your company? (Organization, cost, time, process...)
(6) In what way has the internal control over financial reporting changed after the implementation of SOX?

Outcome of Sarbanes-Oxley in terms of reduction of material errors in financial reports

(7) What was the role of the auditors when implementing SOX?
(8) How has the role of the auditors evolved before (and after) the implementation of SOX?
(9) What kind of changes have SOX brought in the financial statements?

Internal control over financial reporting and European perspective

(10) How would you describe the European and national reactions to SOX?
(11) How does national or European legislation regarding internal control over financial reporting impact your company?

Global assessment

(12) What are the unexpected consequences following the implementation of SOX?
(13) Why are you satisfied (or not satisfied) with the adoption of the internal control aspects of SOX?
(14) Why would you recommend (or not recommend) other companies to adopt SOX section 404, or a similar model in terms of internal control?
For Immediate Release
2007-101

Washington, D.C., May 23, 2007 — The Securities and Exchange Commission today unanimously approved interpretive guidance to help public companies strengthen their internal control over financial reporting while reducing unnecessary costs, particularly at smaller companies. The new guidance will enhance compliance under Section 404 of the Sarbanes-Oxley Act of 2002 by focusing company management on the internal controls that best protect against the risk of a material financial misstatement.

“Congress never intended that the 404 process should become inflexible, burdensome, and wasteful. The objective of Section 404 is to provide meaningful disclosure to investors about the effectiveness of a company’s internal controls systems, without creating unnecessary compliance burdens or wasting shareholder resources,” said SEC Chairman Christopher Cox. “With the Commission’s new interpretive guidance for management on the evaluation and assessment of its internal controls over financial reporting, companies of all sizes will be able to scale and tailor their evaluation procedures according to the facts and circumstances. And investors will benefit from reduced compliance costs.”

“Our guidance enables companies of all sizes to focus on what truly matters to the integrity of the financial statements – risk and materiality,” said Conrad Hewitt, Chief Accountant. “Providing management with its own guidance for evaluating internal control over financial reporting will ensure an appropriate balance between management’s evaluation process and the audit process. While the guidance is intended to help public companies of all sizes, smaller companies, which will begin complying with Section 404 this year, should benefit from its scalability and flexibility. We have also worked closely with the PCAOB to better align our interpretative guidance and the PCAOB’s proposed auditing standard, which the PCAOB will consider for adoption tomorrow.”

“As investors have made clear, Section 404 serves a critically important role in fostering the reliability of financial statements upon which investors and our markets depend. The guidance issued today achieves a significant step in the roadmap the Commission laid out a year ago for improving the implementation of Section 404 for public companies of all sizes and their investors alike,” said John W. White, Director of the SEC’s Division of Corporation Finance. “The Commission and its staff have been focused on improving Section 404 implementation for some time, and our efforts have been considerably aided by the public comment process and helpful insights and suggestions that various interested persons have provided us. The Commission’s interpretive guidance should reduce uncertainty about what constitutes a reasonable approach to management’s evaluation while maintaining flexibility for companies that have already developed their own assessment procedures and tools that serve the company and its investors well. Companies will be able to continue...
using their existing procedures if they choose, provided of course that those meet the standards of Section 404 and our rules.”

The Commission also approved rule amendments providing that a company that performs an evaluation of internal control in accordance with the interpretive guidance satisfies the annual evaluation required by Exchange Act Rules 13a-15 and 15d-15. The Commission also amended its rules to define the term “material weakness” as “a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.” The Commission also voted to revise the requirements regarding the auditor’s attestation report on the effectiveness of internal control over financial reporting to more clearly convey that the auditor is not evaluating management’s evaluation process but is opining directly on internal control over financial reporting.

The effective date of the interpretive guidance and adopted rules will be 30 days from their publication in the Federal Register. The full text of the interpretive guidance and rules will be posted to the SEC Web site as soon as possible. The new auditing standard will be subject to Commission approval in the coming months after its adoption by the PCAOB and, if approved, is expected to be effective no later than for calendar year 2007 audits, with early adoption encouraged.

APPENDIX 4: SECTION 404 OF SARBANES-OXLEY

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.
APPENDIX 5: CONCORDIABUS

CONCORDIA BUS INTERNAL DOCUMENT EXAMPLE OF RISK ASSESSMENT PROCESS

The risk assessment was made to management for cutting off the tail. We found that all risks belonged to certain groups:

- Fleet
- Authority
- IT
- Personnel
- Revenue

But decided to go for the process-oriented view of risks. The newly implemented process owner for Concordia will drive Main risks applicable for each process. The split turned to:

- Deliver Traffic
- Management
- IT
- HR
- Finance

To involve as many new process owners as possible, also Sales and Start traffic received risks to work with

- Sales / Contracts
- Start & End Traffic

Remaining risks are put on "surveillance list" for review in 6 months. Process owner shaped its team, with support from the project. Kick-start with joint team meeting will be scheduled.